PART VIII: PENSION AND PROFIT SHARING

Plan Types and Features

3665. What qualification requirements apply to each type of plan?

Although qualification requirements (Q 3758 to Q 3832) and deduction limits (Q 3834 to Q 3840) generally affect all qualified plans, there are additional qualification requirements and deduction limits that are specific to certain types of plans.

As a general rule, qualification requirements can be divided between: (1) defined benefit plans (Q 3666 to Q 3673) and defined contribution plans (Q 3674 to Q 3679), and (2) pensions (Q 3681 to Q 3693) and profit sharing plans (Q 3694 to Q 3696).

To some degree, these categories overlap. For example, all defined benefit plans are pensions, but not all pensions are defined benefit plans (Q 3681). Similarly, all profit sharing plans are defined contribution plans, but not all defined contribution plans are profit sharing plans; some are pensions.

Furthermore, special qualification, design, and nondiscrimination requirements apply to 401(k) plans (Q 3697 to Q 3733). Section 412(i) plans, although subject to the general requirements for defined benefit plans, must meet special requirements (Q 3734 and Q 3735) to be exempt from certain funding standards (Q 3687 to Q 3693). Stock bonus plans and ESOPs are subject to their own special requirements (Q 3738 to Q 3747). There also are special rules for Keogh and S corporations plans (Q 3748 to Q 3750).

Limitations on an employer's deduction for plan contributions generally are based on whether the plan is a pension (Q 3683) or a profit sharing plan (Q 3695).

Plans that offer insurance benefits are subject to the special rules explained in Q 3751 (for plans that offer life or health insurance to participants) and Q 3756 (for plans that transfer pension assets to Section 401(h) accounts).

3666. What is a defined benefit plan?

The IRC permits two types of qualified plans: defined benefit plans, and defined contribution plans (Q 3674). All defined benefit pension plans are structured as pension plans (Q 3681), while defined contribution plans may be structured as pension or profit sharing plans. A defined benefit plan is a qualified retirement plan that expresses the participant's benefit as a certain amount, either as an exact dollar amount or a formula that determines the amount that will be paid at retirement. That is how the benefit is defined, but the contribution is determined by an actuary. The IRC states that the term "defined benefit plan" means any plan that is not a defined contribution plan.[1]

1. IRC Sec. 414(j).

Variations on the traditional defined benefit plan include Section 412(i) plans (Q 3734) and cash balance plans (Q 3669). See Q 3677 for the application of the Section 415 requirements to defined benefit plans, and Q 3667 for special qualification requirements.

3667. What special qualification requirements apply to defined benefit pension plans?

A defined benefit pension plan may not exclude from participation employees who are beyond a specified age, but the benefit of an employee who is within five years of normal retirement age when employment begins is computed using a retirement age that is the fifth anniversary of the time that plan participation begins for that employee.[1] In addition, a defined benefit plan must benefit a minimum number or percentage of employees (i.e., the 50/40 test) as explained below.

A defined benefit plan must contain a limit on the projected "annual benefit" under the plan or under all such plans aggregated if the employer has more than one defined benefit plan (Q 3784, Q 3668).

A defined benefit plan other than a fully insured plan must satisfy one of the following three accrued benefit tests:

The 3 percent test. The accrued benefit to which a participant is entitled upon separation from service must be not less than 3 percent of the normal retirement benefit to which the participant would have been entitled if the participant commenced participation at the earliest entry age under the plan and served continuously until the earlier of age sixty-five or the normal retirement age specified under the plan, multiplied by the number of years (not in excess of 33⅓) of participation in the plan.[2]

The 133⅓ percent test. In any particular plan year when qualification of the plan is tested, the plan must not allow for the annual rate of accrual of an individual's normal retirement benefit in any later plan year to exceed 133⅓ percent of the annual rate of accrual in any previous year.[3]

The fractional (or pro rata) test. The accrued benefit to which a participant is entitled upon his or her separation from service must be not less than a fraction of the participant's assumed retirement benefit, the numerator of which is the participant's total number of years of participation in the plan and the denominator of which is the total number of years the participant would have participated in the plan had the participant separated from service at normal retirement age.[4] The participant's assumed retirement benefit is computed as though the participant had continued to earn the same rate of compensation annually that he or she had earned during the years that would have been taken into account under the plan

1. IRC Secs. 410(a)(2), 411(a)(8).
2. IRC Sec. 411(b)(1)(A); Treas. Reg. §1.411(b)-1(b)(1).
3. IRC Sec. 411(b)(1)(B); Treas. Reg. §1.411(b)-1(b)(2).
4. IRC Sec. 411(b)(1)(C); Treas. Reg. §1.411(b)-1(b)(3).

(but not in excess of ten years of service immediately preceding separation) had the participant reached normal retirement age at the date of his or her separation. For the calculation method (and examples) that will produce the lowest accrued benefit satisfying the fractional test where benefits are accrued following a break in service, see Revenue Ruling 81-11.[1]

A fully insured plan (or a Section 412(i) plan, named after the IRC section formerly covering such plans) automatically satisfies any of the foregoing accrued benefit tests if (1) the plan is funded exclusively by insurance contracts calling for level annual premiums from the date the insured becomes a participant in the plan to not later than retirement age, (2) benefits provided by the plan are equal to the benefits provided under each contract at normal retirement age and are guaranteed by the insurer, and (3) an employee's accrued benefit at any time is not less than the cash surrender value his or her insurance contracts would have on the assumption that all premiums currently due are paid and there is no indebtedness against the contracts.[2] See Q 3734 and Q 3735 for details on fully insured plans.

A plan funded exclusively by group insurance or group annuity contracts is considered a fully insured (Section 412(i)) plan if the contract has the requisite characteristics of individual contracts.[3] The IRS has taken the position that, for example, amounts received by an insurer under a group contract must be allocated to purchase individual benefits for participants: "A plan which maintains unallocated funds in an auxiliary trust fund or which provides that an insurance company will maintain unallocated funds in a separate account, such as a group deposit administration contract, does not satisfy the requirements of … [a fully insured plan]."[4]

If at the time an employee separates from service the value of his or her employee contributions exceeds the cash surrender value of the insurance contract(s) funding the employee's retirement benefit, the plan could supplement the cash surrender value or values to satisfy the minimum vesting standard and the plan would not fail to be a fully insured plan.[5]

A defined benefit plan that provides a stated benefit offset by the benefits of a profit sharing plan will satisfy the benefit accrual requirements if the benefit determined without the offset satisfies the requirements and if the offset is equal to the amount deemed provided by the vested portion of the account balance in the profit sharing plan on the date the amount of the offset is determined.[6]

A defined benefit plan must require separate accounting for the portion of each employee's accrued benefit derived from any voluntary employee contributions permitted under the plan.[7] Revenue Ruling 78-202[8] discusses the rules relating to calculation of accrued benefits derived from mandatory employee contributions.[9] A plan generally may not be amended to

1. 1981-1 CB 227.
2. IRC Sec. 411(b)(1)(F).
3. IRC Sec. 412(e)(3), as redesignated by PPA 2006.
4. Treas. Reg. §1.412(i)-1(c)(2)(v).
5. Treas. Reg. §1.412(i)-1(b).
6. Rev. Rul. 76-259, 1976-2 CB 111.
7. IRC Sec. 411(b)(2).
8. 1978-1 CB 124.
9. See also Rev. Rul. 79-259, 1979-2 CB 197.

reduce a participant's accrued benefit.[1] Procedures for obtaining approval of a retroactive plan amendment reducing a participant's accrued benefit are specified in Revenue Procedure 94-42.[2]

In addition, if a defined benefit plan subject to the minimum funding rules adopts an amendment that would increase current liability under the plan, and the funded current liability percentage under the plan (the ratio of the value of the plan's assets to its current liability) is less than 60 percent, the plan must require that the amendment will not become effective until the employer (or a member of the employer's controlled group) provides adequate security in favor of the plan.[3] See also Q 3758 to Q 3833 and Q 3684 for other qualification requirements.

In plan years beginning after December 31, 2007, defined benefit plans that are "at risk" (Q 3689) became subject to a qualification requirement that suspends many benefit increases, plan amendments, and accruals in single-employer plans when funding falls below specified levels ranging from 60 percent to 80 percent.[4] Notice must be provided to participants and beneficiaries when funding falls below 60 percent.[5] If a single employer plan in bankruptcy is funded at or above 80 percent, the plan may adopt an amendment, after November 8, 2012, to eliminate an optional or form of benefit that includes a prohibited payment under IRC Section 436(d)(5), if certain conditions are met.[6] See Q 3688 for the funding requirements applicable in plan years beginning after 2007. There is a relief provision in the WRERA 2008 for plan years beginning after September 2008 and before October 2009.[7]

A defined benefit plan also must benefit the lesser of (a) fifty employees or (b) the greater of (i) 40 percent of all employees or (ii) two employees (or if there is only one employee, that employee).[8] Governmental plans are not subject to this 50/40 test.[9]

Defined benefit plans must meet the participation requirement on each day of the plan year. Under a simplified testing method, a plan is treated as satisfying this test if it satisfies it on any single day during the plan year so long as that day is reasonably representative of the employer's workforce and the plan's coverage. A plan does not have to be tested on the same day each plan year.[10] Final regulations provide that a plan that does not satisfy the test for a plan year may be amended by the fifteenth day of the tenth month after the close of the plan year to satisfy the test retroactively.[11] Comparable plans may not be aggregated for purposes of meeting this test.[12]

1. Treas. Reg. §1.411(d)-4, A-1.
2. 1994-1 CB 717.
3. IRC Sec. 401(a)(29).
4. See IRC Secs. 401(a)(29), 436. See Prop. Treas. Reg. §4011.27; Treas. Reg. §1.436-1.
5. Notice 2012-46, -2 CB 86.
6. 77 F.R. 66915 (Nov. 8, 2012) (adding Treas. Reg. §1.411(d)-4 A-2(b)(2)(xii)).
7. WRERA 2008, Sec. 203.
8. IRC Sec. 401(a)(26).
9. See IRC Sec. 401(a)(26)(G).
10. Treas. Reg. §1.401(a)(26)-7(b).
11. Treas. Reg. §1.401(a)(26)-7(c), Treas. Reg. §1.401(a)(4)-11(g).
12. General Explanation—TRA '86, p. 683.

The 50/40 test may be applied separately with respect to each separate line of business if an employer makes an election to which the Secretary of the Treasury consents.[1] Furthermore, the requirement that a separate line of business have at least fifty employees generally does not apply in determining whether a plan satisfies the 50/40 test on a separate line of business basis.[2]

A defined benefit plan's prior benefit structure also must satisfy the minimum participation rule.[3] The prior benefit structure under a defined benefit plan for a plan year includes all benefits accrued to date under the plan, and each defined benefit plan has only one prior benefit structure. A prior benefit structure satisfies the minimum participation rule if the plan provides meaningful benefits to a group of employees that includes the lesser of fifty employees or 40 percent of the employer's employees. Whether a plan is providing meaningful benefits, or whether the employees have meaningful accrued benefits under a plan, is determined on the basis of all the facts and circumstances.[4]

The same employees who are excludable under the coverage tests (Q 3762) generally may be excluded from consideration in meeting the 50/40 participation test.[5] If employees who do not meet a plan's minimum age and service requirements are covered under a plan that meets the 50/40 test separately with respect to such employees, those employees may be excluded from consideration in determining whether other plans of the employer meet the 50/40 test, but only if (1) the benefits for excluded employees are provided under the same plan as benefits for other employees, (2) the benefits provided to excluded employees are not greater than comparable benefits provided to other employees under the plan, and (3) no highly compensated employee is included in the group of excluded employees for more than one year.[6]

An employee generally is treated as benefiting under a plan for a plan year if the employee actually accrues a benefit for the plan year. An employee who fails to accrue a benefit merely because of the IRC Section 415 limits (Q 3784, Q 3668) or a uniformly applicable benefit limit under the plan's structure is treated as benefiting under a plan for the plan year.[7]

As to which individuals must be treated as "employees" and which organizations make up an employer, see Q 3825, Q 3826, Q 3830, and Q 3832.

3668. How are Section 415 limits applied to defined benefit plans?

In a defined benefit plan, the highest annual benefit payable under the plan (or under all such plans aggregated, if the employer has more than one) must not exceed the lesser of 100 percent of the participant's average compensation in his or her high three years of service or $210,000 (in 2014, as indexed, up from $205,000 in 2013).[8] Regulations specify that this limit also applies

1. IRC Sec. 401(a)(26)(A).
2. IRC Sec. 401(a)(26)(F).
3. Treas. Reg. §1.401(a)(26)-1(a).
4. Treas. Regs. §§1.401(a)(26)-3(b), 1.401(a)(26)-3(c).
5. IRC Sec. 401(a)(26)(B)(i); Treas. Reg. §1.401(a)(26)-6.
6. IRC Sec. 401(a)(26)(B)(ii); Treas. Reg. §1.401(a)(26)-6(b)(1).
7. Treas. Regs. §§1.401(a)(26)-5(a), 1.410(b)-3(a)(2)(iii).
8. IRC Sec. 415(b)(1); Notice 2013-86 (Oct. 31, 2013.

to the annual benefit payable to a participant.[1] The regulations referenced throughout this question were issued April 5, 2007, and generally are effective for limitation years beginning after June 30, 2007.[2] For general rules affecting the application of the Section 415 limits, see Q 3784; for the defined contribution plan limits, see Q 3677.

In plan years beginning after 2005, a participant's high three years of service is the period of three consecutive calendar years during which the participant had the greatest aggregate compensation from the employer.[3] Regulations state that a plan may not base accruals on compensation in excess of the Section 401(a)(17) limit ($260,000 in 2014 and $255,000 in 2013, as indexed).[4] For plan years beginning prior to January 1, 2006, a participant's high three years of service had to be three consecutive years in which he or she was both an active participant in the plan and had the greatest aggregate compensation from the employer.

For purposes of defined benefit limits, "annual benefit" means a benefit that is payable annually in the form of a straight annuity. If the benefit is payable in a form other than a straight life annuity, the annual benefit is determined as the straight life annuity that is actuarially equivalent to the form in which the benefit is paid.[5] The application of the Section 415(b) limit to a benefit that is not payable in the form of an annual straight life annuity is explained in Treasury Regulation Section 1.415(b)-1(c). Earlier guidance appeared in Revenue Ruling 2001-51.[6] The "annual benefit" does not include employee contributions and rollover contributions.[7]

Planning Point: In Revenue Ruling 2012-4,[8] the IRS held that a qualified defined benefit plan that accepts a direct rollover of an employee's or former employee's benefit from a qualified defined contribution plan maintained by the same employer does not violate Sections 411 or 415 if the defined benefit plan provides an annuity resulting from the direct rollover that is determined by converting the amount directly rolled over into an actuarially equivalent immediate annuity using the applicable interest rate and applicable mortality table under Section 417(e). If the plan were to provide an annuity using a more favorable actuarial basis than required under Section 411(c), then the portion of the benefit resulting from this more favorable treatment would be included in the annual benefit. This interpretation applies to rollovers made on or after January 1, 2013.

The annual benefit does not include employer contributions to an individual medical account under IRC Section 401(h) (Q 3756) of any individual under a defined benefit pension plan. Such amounts are treated as annual additions to a separate defined contribution plan (Q 3677).[9]

There are special rules requiring an adjustment of the annual benefit where a participant has more than one annuity starting date (for example, where benefits under one plan are aggregated

1. See Treas. Reg. §1.415(b)-1(a)(1).
2. T.D. 9319; 72 Fed. Reg. 16878 (April 5, 2007).
3. IRC Sec. 415(b)(3).
4. See Treas. Reg. §1.415(b)-1(a)(1); Notice 2013-86 (Oct. 31, 2013).
5. See Treas. Reg. §1.415(b)-1(b)(1).
6. 2001-2 CB 427, A-3.
7. See Treas. Reg. §1.415(b)-1(b)(1)(ii).
8. 2012-1 C.B. 386 (Feb. 2, 2012).
9. See IRC Sec. 415(l).

with benefits under another plan from which distributions have already commenced, or where benefits are increased under a cost of living adjustment).[1]

The $210,000 limit (as indexed for 2014) is adjusted downward if the annuity starting date occurs before the participant reaches age sixty-two.[2] If the annuity starting date occurs after the participant reaches age sixty-five, the limit is adjusted upward.[3] The calculation of the adjustments is explained at IRC Section 415(b)(2)(E) and Treasury Regulation Section 1.415(b)-1(d) and (e). Earlier guidance on implementing these adjustments was provided in Revenue Ruling 2001-51.[4]

An adjustment also is required for certain other forms of benefit, as well as for employee contributions and rollover contributions (Q 3880 to Q 3897), so that such benefits are converted to the actuarial equivalent of a straight life annuity.[5] Under earlier guidance this adjustment is more complex, generally following the manner in which Social Security benefits are reduced for Social Security purposes. The interest rate assumption used for making this adjustment must be no less than the greater of 5.5 percent or the rate specified in the plan.[6] In the case of benefits subject to IRC Section 417(e)(3), the interest rate must be the rate set forth in IRC Section 417(e)(3).[7] Guidance and detailed rules for making this calculation appear in Notice 2004-78[8] and in Treasury Regulation Section 1.415(b)-1(c)(3). Simplification for amounts not subject to minimum present value rules of IRC Section 417(e)(3) is set forth in Treasury Regulation Section 1.415(b)-1(c)(2).

Adjustments to the ceiling do not need to be made for ancillary benefits not directly related to retirement benefits (such as preretirement death and disability benefits and postretirement medical benefits).[9] If the benefit is paid in the form of a joint and survivor annuity for the benefit of the participant and the participant's spouse, the value of the feature will not be taken into consideration in reducing the ceiling unless the survivor benefit is greater than the joint benefit.[10]

The 100 percent of compensation limit generally does not apply to governmental plans, multiemployer plans, or certain collectively bargained plans.[11]

The dollar limit and 100 percent compensation limit are subject to a ten year phase-in rule. The $210,000 limit (as indexed for 2014) is reduced by multiplying it by the following fraction: the numerator is the participant's years of participation in the defined benefit plan, and the denominator is 10.[12] The 100 percent of compensation limit is reduced in the same manner,

1. See Treas. Reg. §1.415(b)-1(b)(1)(iii).
2. IRC Sec. 415(b)(2)(C); Treas. Reg. §1.415(b)-1(a)(4); Notice 2013-86 (Oct. 31, 2013).
3. IRC Sec. 415(b)(2)(D); Treas. Reg. §1.415(b)-1(a)(4).
4. 2001-2 CB 427, A-4.
5. IRC Sec. 415(b)(2)(B); see Treas. Reg. §1.415(b)-1(b)(2).
6. Notice 2009-98; 2009-2 C.B. 974.
7. IRC Sec. 415(b)(2)(E)(i); IRC Sec. 415(b)(2)(E)(ii).
8. 2004-48 IRB 879.
9. Treas. Reg. §1.415(b)-1(c)(4). See also, IRS Information Letter, 18 Pens. Rep. (BNA) 1552 (1991); Let. Rul. 9636030.
10. IRC Sec. 415(b)(2)(B).
11. Treas. Reg. §1.415(b)-1(a)(6).
12. IRC Sec. 415(b)(5)(A).

but based on years of service, rather than years of participation.[1] "Years of service," for this purpose, includes employment with a predecessor employer, including affiliated employers.[2] Neither reduction will reduce the limitation to less than 10 percent of the otherwise applicable limitation amount.[3]

A benefit of up to $10,000 in any limitation year may be provided to a participant without violating the IRC Section 415 limits, notwithstanding the 100 percent limit or required adjustments for ancillary benefits. This benefit, however, is subject to the ten year phase-in rule described above, based on years of service. The participant must not at any time also have participated in a defined contribution plan maintained by the employer.[4]

A plan may incorporate by reference the automatic adjustments of plan benefits to the extent of the annual cost-of-living increases provided under the IRC. The scheduled benefit increases may not take effect earlier than the year in which the dollar limit adjustment becomes effective.[5] Regulations state that the annual increase does not apply in limitation years beginning after the annuity starting date to a participant who previously has commenced receiving benefits unless the plan so specifies.[6] Earlier regulations stated that a plan could provide for automatic freezing or reduction of the rate of benefit accrual to prevent the limitations from being exceeded.[7]

A defined benefit plan may maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit under the plan. This kind of arrangement is qualified if the adjustment is based on increases in the cost-of-living after the annuity starting date, determined by reference to one or more indexes prescribed by the IRS (or a minimum of 3 percent). The arrangement must meet the following requirements:

(1) be elective;

(2) be available to all participants under the same terms;

(3) provide for such election at least in the year the participant attains the earliest retirement age under the plan (determined without regard to any requirement of separation from service) or separates from service; and

(4) exclude key employees.[8]

3669. What is a cash balance plan?

A cash balance plan is a defined benefit plan that calculates benefits and contributions in a manner similar to the way that defined contribution plans make those calculations. The similarity

1. IRC Sec. 415(b)(5)(B).
2. See Treas. Regs. §§1.415(b)-1(g)(2)(ii)(B), 1.415(f)-1(c), 1.415(a)-1(f); see also *Lear Eye Clinic, Ltd. v. Comm.*, 106 TC 418 (1996).
3. IRC Sec. 415(b)(5)(C).
4. IRC Secs. 415(b)(4), 415(b)(5)(B).
5. Treas. Regs. §§1.415(a)-1(d)(3)(v), 1.415(d)-1.
6. See Treas. Reg. §1.415(a)-1(d)(3)(v)(C).
7. Treas. Reg. §1.415-1(d)(1).
8. IRC Sec. 415(k)(2).

ends in that a cash balance plan's calculations require an actuary. A cash balance plan resembles a defined contribution plan in that each employee has a hypothetical account, or "cash balance," to which contributions and interest payments are credited. There is no separate account and the amount credited to the account is based on a provision in the plan document. With no separate account, there is no directed investing available. As with other defined benefit plans, the employer bears both the risk and the benefits of investment performance. That is, losses in the plan's investments generally require additional employer funding.

In a typical cash balance plan, the employee's benefit accrues evenly over his or her years of service, with annual pay credits to a hypothetical account. These pay credits usually are a fixed percentage of pay that is stated in the plan document, such as 4 percent, 30 percent, etc. The actual amount that must be contributed is determined actuarially. This ensures that the plan has sufficient funds to provide the promised benefits.

For plan years beginning in 2012, the interest credit (or the equivalent amount) for any plan year must be at a rate that is not greater than a "market rate" of return. The term "market rate" of return is defined in regulations issued in 2010.[1] A plan will not fail this requirement merely because it provides for a reasonable minimum guaranteed rate of return or for a rate of return equal to the greater of a fixed or variable rate.[2] An interest credit of less than zero may not result in the account balance being less than the aggregate amount of contributions credited to the account.[3] This legislative change eliminates the issue of "whipsaw," in which disparate interest rates used for crediting and discounting purposes resulted in the discounted present value of employees' accounts being higher than the theoretical account's value.

Planning Point: The Moving Ahead for Progress in the 21st Century Act (MAP-21)[4] enacted on July 6, 2012, contained interest-rate stabilization provisions for defined benefit plans. In August 2012, the IRS issued Notice 2012-55,[5] which outlined the MAP-21 segment rates to be used for plan years beginning in 2012.[6] MAP-21 revises the three segment rates used under the single employer funding rules.

The IRS issued Notice 2012-61[7] to provide guidance on pension funding stabilization under MAP-21. The guidance gives flexibility to plan administrators of plans that use the third segment rate by allowing the administrator to interpret the plan terms as requiring either the pre-MAP-21 third segment rate or the MAP-21 third segment rate, as long as the interpretation is applied for interest credited after the first plan year to which MAP-21 is applied for purposes of funding. An amendment to reflect that interpretation will not be considered a plan cutback. The guidance further states that although Treasury Regulation Section 1.411(b)(5)-1(d)(1)(iii), which provides guidance on the definition of "market rate," is effective for plan years beginning after January 1, 2012, the IRS plans to amend the final regulations to postpone the

1. Treas. Reg. §1.411(b)(5)-1(d).
2. 29 U.S.C. §623(i)(1)(B)(i)(I).
3. IRC Sec. 411(b)(5)(B)(i)(II); Treas. Reg. §1.411(b)(5)-1.
4. Pub. L. No. 112-141.
5. 2012-36 I.R.B. 332 (Aug. 16, 2012). See also Notice 2014-43, 2014 IRB LEXIS 399 (July 9, 2014).
6. Notice 2013-11, 2013-11 I.R.B. 610 (Feb. 12, 2013) contains the 2013 MAP-21 stabilized segment rates. See also Notice 2014-43, 2014 IRB LEXIS 399 (July 9, 2014).
7. 2012-2 C.B. 479 (Sept. 11, 2012), at H-1.

effective date until plan years beginning after January 1, 2014.[1] If the final regulations do not state that the third segment rate is a market rate under MAP-21, then the plan sponsor must amend the plan to reflect the proper rate.

3670. What rules apply for converting a traditional defined benefit plan to a cash balance plan?

A traditional defined benefit plan that is converted to a cash balance plan is subject to certain rules on the crediting of participant benefits. The plan's benefit after conversion must not be less than the sum of the participant's accrued benefit for years of service before the conversion under the prior formula, plus the benefit the participant earns under the new formula for service after the conversion.[2] This formula is known by actuaries as an "A+B" approach.

The A+B approach is designed to eliminate a plan issue referred to as "wearaway," which refers to situations where certain participants in the plan do not accrue any additional benefits until benefits under the prior plan are worn away to equal benefits under the new plan. This occurred in some conversions where older employees might not accrue additional benefits under the cash balance formula until their new hypothetical account balance caught up with their prior accrued benefit. Requirements for calculation of the present value of a participant's accrued benefit are set forth in IRC Section 411(a)(13)(A) (effective for distributions made after August 17, 2006).

3671. What vesting requirements apply to cash balance plans?

For plan years beginning after 2007, benefits in cash balance plans must be 100 percent vested after three years of service (service is service for vesting and includes service before the effective date).[3]

3672. What requirements must a cash balance plan meet in order to avoid discriminating based on age under the Pension Protection Act of 2006?

The Pension Protection Act of 2006 ended a long period of uncertainty for cash balance plans by amending the IRC, ERISA, and the Age Discrimination in Employment Act of 1967. The effect of the legislative changes provides that cash balance plans will not be age discriminatory when certain requirements are met.

A preexisting IRC requirement under which cash balance plans had been attacked stated that an employee's benefit accruals may not cease, and the rate accrual may not be reduced, because of the attainment of any age.[4] Three parallel amendments provide that a plan will not be treated as failing this requirement if a participant's accrued benefit, determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger

1. 2012-2 C.B. 479 (Sept. 11, 2012), at H-1 (b).
2. IRC Secs. 411(b)(5)(B)(ii), 411(b)(5)(B)(iii), effective for conversions occurring after June 29, 2005.
3. See IRC Sec. 411(a)(13)(B); Pub. L. 109-280, Sec. 701(e)(3).
4. IRC Sec. 411(b)(1)(H)(i).

individual who is or could be a participant.[1] Except as otherwise indicated below, the provisions of PPA 2006 applicable to cash balance plans are effective for periods after June 28, 2005.[2]

A participant is "similarly situated" if he or she is identical to another individual in every respect except for age; in other words, in circumstances such as period of service, compensation, date of hire, work history.[3]

"Accrued benefit" is defined by the plan terms; it may be expressed as an annuity payable at normal retirement age, the balance of the participant's cash balance plan account, or some other means. Early retirement subsidies, permitted disparity, and certain other plan features are disregarded for this purpose.[4]

Prior to the passage of the PPA, the Seventh Circuit Court of Appeals held that a cash balance plan formula that was age neutral did not give rise to age discrimination under ERISA, and that an employer's choice to convert from a defined benefit plan (which tends to favor older employees) to a cash balance plan (which does not) is not per se age discrimination.[5]

3673. How are the required annual and quarterly payments to single employer defined benefit plans determined?

Contributions to certain defined benefit plans (other than multiemployer or CSEC plans) subject to the minimum funding standard (Q 3687 to Q 3693) must be made, on an estimated basis, at least quarterly. The quarterly contribution requirement is imposed on plans with a funding shortfall in the prior year.[6]

The required amount for each quarterly installment is 25 percent of the required annual payment ("RAP").[7] The RAP is the lesser of the following:

(1) 90 percent of the minimum required contribution amount the employer is required to contribute for the plan year under the minimum funding requirements; and

(2) 100 percent of the minimum required contribution for the preceding plan year (determined without regard to a §412(c) waiver), but only if the preceding plan year consisted of twelve months.[8]

Quarterly contributions are determined without regard to increased contributions.

Defined benefit plans subject to the quarterly contributions requirement also must meet a liquidity requirement[9] and generally must maintain liquid plan assets. A plan will be deemed

1. IRC Sec. 411(b)(5)(A)(i).
2. Pub. L. 109-280, Sec. 701(e).
3. See IRC Sec. 411(b)(5)(A)(ii).
4. See IRC Sec. 411(b)(5)(A)(iv).
5. See *Cooper v. IBM Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006), *rev'g* 274 F. Supp. 2d (S.D. Ill. 2003).
6. IRC Sec. 430(j)(3).
7. IRC Sec. 430(j)(3)(D)(ii).
8. IRC Sec. 430(j)(3)(D) (ii).
9. IRC Sec. 430(j)(4).

to have a liquidity shortfall if, with respect to a quarter, the plan does not have liquid assets in an amount approximately equal to three times the total adjusted disbursements from the plan trust during the twelve month period ending on the last day of each quarter for which the plan must pay a required quarterly installment.[1] A special rule permits this amount to be determined without regard to nonrecurring circumstances, under certain conditions.[2]

The minimum funding requirement for a plan year generally is determined without regard to any credit balance or pre-funding balance as of the beginning of the plan year. A credit balance in the plan's funding standard account may not be treated as a contribution to satisfy the liquidity requirement.

If a required installment is not paid to the plan by its due date, the funding standard account is charged with interest on the amount by which the required installment exceeds the amount, if any, paid on or before such due date. This interest is charged for the period from the due date until the date when the installment actually is paid.[3] The installment due dates are April 15, July 15, October 15, and January 15 of the following year,[4] or, if the plan year is not a calendar year, the fifteenth of each corresponding month in the plan year.[5] The rate of interest charged is the rate of interest used to determine liability plus 5 percent.[6] Additional payments necessary to satisfy the minimum funding requirement are due within 8.5 months after the end of the plan year.

A statutory lien may be imposed on an employer, determined on a controlled group basis (Q 3830), for failure to make a required installment or any other payment required by the minimum funding rules if the aggregate unpaid balance of the contributions or payments (including interest) exceeds $1,000,000.[7]

Defined Contribution Plans

3674. What is a defined contribution plan?

The IRC permits two types of tax qualified plans: defined contribution plans, and defined benefit plans.

A defined contribution plan is characterized by two elements: each participant has an individual account, and all benefits are provided solely from the accumulated value of those accounts based on amounts contributed by employee and employer, forfeiture reallocation and accruals, plus income, expenses, gains and losses.[8] Defined contribution plans contain a formula for determining the amount of the contribution or how a discretionary contribution to the plan is allocated to each participant's account.

1. IRC Sec. 430(j)(4)(E)(ii)(I).
2. IRC Sec. 430(j)(4)(E)(ii)(II).
3. IRC Sec. 430(j)(3)(B(ii).
4. IRC Sec. 430(j)(3)(C)(ii).
5. IRC Sec. 430(j)(3)(E).
6. IRC Sec. 430(j)(3)(A).
7. IRC Sec. 430(k)(1).
8. IRC Sec. 414(i).

A defined contribution plan can be either a pension (Q 3681) or a profit sharing plan (Q 3694). Profit sharing, age weighted and cross-tested profit sharing plans include 401(k) plans (Q 3697), stock bonus plans (Q 3738), and employee stock ownership plans (Q 3739). Pension plans include money purchase and target benefit plans (Q 3682).

See Q 3677 for the application of the Section 415 limits to defined contribution plans and Q 3675 for special qualification requirements.

3675. What special qualification requirements apply to defined contribution plans?

A defined contribution plan must contain a limitation on the amount of "annual additions" that may be credited to a participant's account each year, or, if an employer has more than one plan, to all accounts of all defined contribution plans of the employer (Q 3677, Q 3784). The plan must require a separate accounting for each employee's benefit under the plan.[1] This is accomplished by segregating each type of contribution and its related earnings into a separate account.

A defined contribution plan may not exclude from participation in the plan employees who are beyond a specified age.[2]

Hybrid plans, which combine the features of defined contribution plans and defined benefit plans, are treated as defined contribution plans to the extent that benefits are based on the individual account. One type of hybrid plan is the target benefit plan (Q 3682). The participant's target benefit is calculated according to a formula, and an actuary determines the contribution necessary to reach this target by retirement age. This amount is allocated to the participant's account.

A defined contribution plan must provide for (1) allocation of contributions and trust earnings to participants in accordance with a definite formula, (2) distributions in accordance with an amount stated or otherwise ascertainable and credited to participants, and (3) a valuation of investments held by the trust, at least once a year, on a specified inventory date, in accordance with a method consistently followed and uniformly applied.[3] The third requirement may be satisfied in a plan where contributions are invested solely in insurance contracts or in mutual fund shares even if there is no provision in the plan for periodic valuation of assets.[4]

A defined contribution plan will not fail to satisfy the participation, coverage, and vesting requirements merely because it does not unconditionally provide for an allocation to a participant with respect to a computation period in which he or she completes 1,000 hours of service (Q 3761, Q 3785). Thus, for example, a plan may require that a participant be employed as of

1. IRC Sec. 411(b)(2)(A).
2. IRC Sec. 410(a)(2).
3. Rev. Rul. 80-155, 1980-1 CB 84.
4. Rev. Rul. 73-435, 1973-2 CB 126; Rev. Rul. 73-554, 1973-2 CB 130.

the last day of a computation period to receive an allocation.[1] This provision will not violate nondiscrimination requirements (Q 3764).

A money purchase pension plan or a profit sharing plan will not be qualified unless the plan designates the type of plan it is.[2] The IRS has ruled that amounts transferred or directly rolled over from a money purchase pension plan to an otherwise qualified profit sharing plan must continue to be subject to the restrictions on money purchase pension plans. In the absence of such restrictions, the profit sharing plan would fail to qualify under IRC Section 401(a).[3]

3676. What diversification and vesting requirements apply to defined contribution plans that provide for acquisition of employer stock?

In plan years beginning after December 31, 2006, a diversification requirement applies to certain defined contribution plans that hold publicly-traded employer securities (Q 3680).[4]

A qualified defined contribution plan, other than a profit sharing plan, that is established by an employer whose stock is not readily tradable on an established market and that holds more than 10 percent of its assets in employer securities must provide that plan participants are entitled to exercise voting rights with respect to employer stock held by the plan with respect to approval of corporate mergers, consolidations, recapitalizations, reclassifications, liquidation, dissolution, sales of substantially all of the business's assets, and similar transactions as provided in future regulations. Each participant must be given one vote with respect to an issue, and the trustee must vote the shares held by the plan in a proportion that takes into account the one participant/one vote requirement.[5]

3677. How are Section 415 limits applied to defined contribution plans?

Annual additions include employee contributions, employer contributions, and forfeitures. The annual additions to a participant's account (or all such accounts aggregated, if the employer has more than one defined contribution plan) must not exceed the lesser of 100 percent of the participant's compensation or $52,000 (as indexed for 2014, up from $51,000 for 2013).[6] This limit is indexed for inflation in increments of $1,000.[7]

Limitations applicable when an individual is a participant in one or more elective deferral plans (including 401(k) plans, SIMPLE IRAs, SAR-SEPs, and tax sheltered annuities) are explained in Q 3705. For general rules affecting the application of the Section 415 limits, see Q 3784; for defined benefit plan limits, see Q 3668. The regulations referenced throughout this question were issued April 5, 2007 and are effective for limitation years beginning after June 30, 2007.[8]

1. See Treas. Regs. §§1.410(b)-3(a)(1), 1.410(b)-6(f)(3), 1.401(a)(26)-5(a)(1).
2. IRC Sec. 401(a)(27)(B).
3. Rev. Rul. 94-76, 1994-2 CB 46; amplified by Rev. Rul, 2002-42, 2002-2 CB 76.
4. IRC Sec. 401(a)(35).
5. IRC Secs. 401(a)(22), 409(e).
6. IRC Sec. 415(c); Notice 2012-67 (Dec. 10, 2012), IR-2013-86 (Oct. 31, 2013).
7. IRC Sec. 415(d)(4)(B).
8. T.D. 9319, 72 Fed. Reg. 16878 (April 5, 2007).

The following amounts are not annual additions:

(1) catch-up contributions (Q 3706);

(2) payments made to restore losses resulting from a breach of fiduciary duty;

(3) excess deferrals that are distributed as required in regulations (Q 3705), and

(4) certain restorations of accrued benefits.[1]

Earlier regulations provide for corrective measures when contributions in excess of the Section 415 limits (i.e., excess annual additions) are made due to the allocation of forfeitures, due to reasonable error in estimating a participant's compensation, or under certain other limited circumstances.[2] The preamble to the 2007 regulations states that guidance on this subject is in the Employee Plans Compliance Resolution System (EPCRS).[3]

Compensation to which the limit is applied is the compensation for the limitation year from the employer maintaining the plan.[4] It includes wages, salaries, fees for professional services, and other amounts for services actually rendered (such as commissions, percentage of profits, tips, and bonuses).[5] Compensation also includes (i) elective deferrals to 401(k) plans, SAR-SEPs, SIMPLE IRAs, and Section 457(b) plans to the extent not includable in the employee's income and (ii) any amounts contributed or deferred by the election of the employee and excluded from gross income of the employee under IRC Sections 125 (cafeteria plans), 132(f) (qualified transportation fringe benefit plans), or 457 (deferred compensation plan of a government or tax-exempt organization).[6] The foregoing items may be used as a simplified safe harbor definition of compensation.[7]

The regulations also permit the following to be included as compensation to the extent they are includable in the gross income of the employee: certain payments received under an employer's accident and health plan, certain moving expense reimbursements, the value of nonqualified options in the year granted, and certain property transferred in connection with the performance of services.[8]

In the case of a self-employed person, his earned income is compensation.[9]

Except as noted above, compensation does not include nontaxable employer contributions toward deferred compensation plans, qualified or nonqualified, in the year in which they were contributed. Furthermore, deferred compensation distributions are not compensation when

1. Treas. Reg. §1.415(c)-1(b)(2)(ii); IRC Sec. 414(v)(3)(A). See also Rev. Rul. 2002-45, 2002-2 CB 116.
2. Treas. Reg. §1.415-6(b)(6) (removed effective April 5, 2007).
3. See Rev. Proc. 2006-27, 2006-22 IRB 945, modified and superseded by Rev. Proc. 2007-49, 2007-2 C.B. 141 and Rev. Proc. 2013-12, 2013-4 IRB 313.
4. IRC Sec. 415(c)(3)(A).
5. Treas. Reg. §1.415(c)-2(b)(1).
6. See IRC Secs. 415(c)(3), 402(g).
7. Treas. Reg. §1.415(c)-2(d)(2).
8. Treas. Reg. §1.415(c)-2(b)(3) to (6). See also Treas. Reg. §1.415(c)-2(d)(2).
9. IRC Sec. 415(c)(3)(B).

received whether or not excludable from gross income, except that distributions of unfunded nonqualified deferred compensation may be considered compensation in the year in which they are includable in gross income.[1] Excludable premiums for group term life insurance are not compensation.[2] Foreign source income generally will be treated as compensation even though excluded from gross income.[3]

The compensation must be *actually paid or made available* to be taken into account within the limitation year.[4] Compensation includes compensation from all employers that are members of a controlled group of corporations or a group of trades or businesses under common control.[5] Regulations also provide for safe harbors based on wages for income tax withholding or wages as reported in Box 1 on Form W-2.[6]

Post-severance compensation of the following amounts is included as compensation if paid within 2½ months following severance from employment: (1) payment for unused sick or vacation leave the employee could have used had employment continued or (b) amounts that would have been paid had employment continued, such as compensation and overtime, commissions, bonuses, or similar compensation. It should be noted that this treatment will not apply to other types of post-severance packages, such as parachute payments under IRC Section 280G and unfunded nonqualified deferred compensation.[7]

Any amount allocated to a separate account that is required to be established in a welfare benefit fund (Q 3971) to provide postretirement medical or life insurance benefits to a key employee (Q 3828) must be treated as an annual addition to a separate defined contribution plan for purposes of calculating the annual additions to defined contribution plans of an employer.[8] Such amounts are not subject to the 100 percent of compensation limit under IRC Section 415(c)(1)(B) discussed above.

While *annual additions* are the sum credited to a participant's account for any limitation year, of (1) employer contributions, (2) employee contributions, and (3) forfeitures, "employee contributions" do not include rollovers from another qualified plan or from an IRA (Q 3880), contributions under IRC Section 457(e)(6), or employee contributions to a SAR-SEP (Q 3650) that are excludable from the employee's gross income.[9] A direct transfer of funds or employee contributions from one defined contribution plan to another will not be considered an annual addition for the limitation year in which the transfer occurs.[10]

A corrective allocation to a participant's account because of an erroneous forfeiture or a failure to make a required allocation in a prior limitation year will not be considered an annual

1. Treas. Reg. §1.415(c)-2(c)(1).
2. Treas. Reg. §1.415(c)-2(c)(4).
3. Treas. Reg. §1.415(c)-2(g)(5).
4. Treas. Reg. §1.415(c)-2(e)(1)(i).
5. Treas. Reg. §1.415(c)-2(g)(2).
6. Treas. Reg. §1.415(c)-2(d).
7. Treas. Reg. §1.415(c)-2(e)(3).
8. IRC Sec. 419A(d)(2).
9. See IRC Sec. 415(c)(2).
10. See Treas. Reg. §1.415(c)-1(b)(1); Let. Ruls. 9111046, 9052058.

addition for the limitation year in which the allocation is made, but will be considered an annual addition for the limitation year to which the corrective allocation relates.[1]

Restorative payments made to a defined contribution plan, to the extent they restore plan losses that result from a fiduciary breach (or a reasonable risk of liability for a fiduciary breach), are not contributions for purposes of IRC Section 415(c). In contrast, payments made to a plan to make up for losses due to market fluctuations, but not due to a fiduciary breach, *will* be treated as contributions, not as restorative payments.[2]

Earlier regulations stated that if an allocation of forfeitures or a reasonable error in estimating a participant's annual compensation would cause additions to exceed the limit, they may, under certain circumstances, be held in suspense, be used to reduce employer contributions for that participant or be returned to the participant.[3] (A return of mandatory contributions could result in discrimination). Certain other transactions between a plan and an employer, or certain allocations to participants' accounts, could be treated as giving rise to annual additions.[4]

Generally, an employer may elect to continue contributions under a profit sharing or stock bonus plan on behalf of permanently and totally disabled participants.[5] For the purpose of determining whether such contributions comply with the limitation on contributions, the disabled participant's compensation is deemed to be the amount of compensation he would have received for the year if paid at the rate of compensation he received immediately before becoming permanently and totally disabled. Contributions made under this provision *must* be nonforfeitable when made.[6] The IRS has privately ruled that a 401(k) plan that purchased a group long-term disability income policy to insure the continuation of benefit accumulation for disabled employees would not be required to include amounts paid under the policy as annual additions.[7]

A defined contribution plan may provide for an automatic adjustment which reflects the cost-of-living increases in the limit on annual additions.[8] Like defined benefit plans, the plan may provide for automatic freezing or reduction in the rate of annual additions to prevent exceeding the limitation.[9]

In the case of an ESOP, if no more than one-third of the deductible employer contributions applied by the plan to the repayment of principal and interest on loans incurred to acquire qualifying employer securities are allocated to highly compensated employees (Q 3827), forfeitures of employer securities acquired with such loans and deductible employer contributions applied by the plan to the payment of interest on such loans may be excluded for purposes

1. See Rev. Proc. 2013-12, 2013-4 IRB 313, 6.02(4)(b); Treas. Reg. §1.415(c)-1(b)(6)(ii)(A).
2. Rev. Rul. 2002-45, 2002-2 CB 116; Treas. Reg. §1.415(c)-1(b)(2)(ii)(C). See also Let. Ruls. 9506048, 9628031.
3. Treas. Reg. §1.415-6(b)(6), prior to removal by T.D. 9319.
4. Treas. Reg. §1.415-6(b)(2)(i), prior to removal by T.D. 9319.
5. IRC Sec. 415(c)(3)(C).
6. IRC Sec. 415(c)(3)(C).
7. Let. Ruls. 200031060, 200235043.
8. Treas. Reg. §1.415(a)-1(d)(3).
9. Treas. Reg. §1.415(a)-1(d)(1).

of the limitations on contributions.[1] Where an employer reversion is transferred to an ESOP, amounts in excess of the Section 415 limit which are held in a reversion suspense account are not deemed to be annual additions until the limitation year in which they are allocated to the participants' accounts.[2]

3678. What are savings and thrift plans?

Savings and thrift plans are defined contribution plans that have employee contributions. The terms generally refer to plans where the employee contributions are made with after-tax employee contributions. These plans were more common before 401(k) plans were introduced. Today, some practitioners use these terms also to describe plans where employees make contributions on a pre-tax basis (i.e., 401(k) plans). These plans typically feature employer-matching contributions. The IRC makes no specific provision for these plans, but they may be tax qualified if they meet the requirements for a pension, profit sharing, or stock bonus plan. A savings or thrift plan may qualify as a pension plan unless there are preretirement privileges to withdraw benefits. They frequently qualify as profit sharing plans by providing for employer contributions out of current or accumulated profits.

3679. What special rules apply to the sale of employer securities to a defined contribution plan?

The IRC permits employers to make contributions to certain qualified plans in the form of employer stock, if the plan permits.[3] The restrictions on prohibited transactions normally limit these contributions to certain profit sharing plans and plans established as employee stock ownership plans ("ESOPs").[4] ESOPs also are permitted to purchase stock from the employer under a complex set of ERISA and IRC provisions.

Planning Point: No employer should consider such a transfer or sale unless the decision is coordinated with ERISA-qualified legal counsel.

3680. What is the diversification requirement for defined contribution plans?

In plan years beginning after December 31, 2006, defined contribution plans (other than certain ESOPs) that hold publicly traded employer securities must satisfy a diversification requirement to be qualified.[5] In May 2010, the IRS issued final regulations on the diversification requirement.[6] The final regulations are effective for plan years beginning on or after January 1, 2011.[7] Until that effective date, a plan was required to comply with the diversification requirement, but could rely on the proposed regulations, or the final regulations for purposes of satisfying the requirements of IRC Section 401(a)(35).

1. IRC Sec. 415(c)(6). See Treas. Reg. §1.415(c)-1(f).
2. IRC Sec. 4980(c)(3)(C); Let. Ruls. 8935056, 8925096.
3. IRC Sec. 409.
4. IRC Sec. 4975.
5. IRC Sec. 401(a)(35), ERISA Sec. 204(j).
6. Treas. Reg. §1.401(a)(35)-1.
7. Treas. Reg. §1.401(a)(35)-1.

Defined contribution plans subject to this requirement must permit participants to direct the plan to divest the portion of their account attributable to employee contributions and elective deferrals invested in employer securities, and reinvest an equivalent amount in other investment options.[1] With respect to employer contributions only, the diversification feature may be restricted to participants with at least three years of service, their beneficiaries, and the beneficiaries of deceased participants.[2]

The plan must offer at least three investment options (other than employer securities) to which an employee affected by this provision may direct the proceeds from the divestment of the employer securities. Each investment option must be diversified and have materially different risk and return characteristics.[3] A plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities, provided they occur at least quarterly. If the plan places restrictions or conditions (other than the application of securities laws) with respect to the investment of employer securities that are not imposed on the investment of other assets in the plan, it will not satisfy the provisions of the diversification requirement.[4]

The application of the diversification requirement to employer contributions is phased in ratably over three years. The phase-in does not apply to participants who reached age fifty-five and completed three years of service before the first plan year beginning after December 31, 2005. Under the phase-in, an "applicable percentage" of the portion of an account attributable to employer contributions (other than elective deferrals) invested in employer securities is subject to the requirement as follows: 33 percent after the first plan year, 66 percent after the second plan year, and 100 percent after the third and subsequent plan years. This transition rule applies only to securities acquired before January 1, 2007.[5]

The diversification requirement does not apply to certain ESOPs. If an ESOP does not hold any 401(k) contributions, Section 401(m) match amounts, or earnings attributable to them and the plan is a separate plan for purposes of the merger and consolidation requirements of IRC Section 414(l) with respect to any other defined benefit or defined contribution plan of the same employer or employers, then the ESOP will be excluded from this requirement.[6]

Planning Point: The IRS has issued relief from the anti-cutback rules of Section 411(d)((6) for a plan sponsor who amends a non-exempt ESOP to eliminate a distribution option that had previously satisfied the diversification requirements of Section 401(a)(28)(B) if the amendment occurs no later than the last day of the first plan year beginning on or after January 1, 2013 or by the deadline for the plan to satisfy Section 401(a)(35), if later.[7]

Publicly traded employer securities for purposes of this requirement means employer securities that are readily tradable on an established securities market.[8]

1. IRC Sec. 401(a)(35)(B); Treas. Reg. §1.401(a)(35)-1(b).
2. IRC Sec. 401(a)(35)(C); Treas. Reg. §1.401(a)(35)-1(e).
3. IRC Sec. 401(a)(35)(D)(i); Treas. Reg. §1.401(a)(35)-1(d).
4. IRC Sec. 401(a)(35)(D)(ii); Treas. Reg. §1.401(a)(35)-1(e).
5. IRC Sec. 401(a)(35)(H); Treas. Reg. §1.401(a)(35)-1(g)(3).
6. IRC Sec. 401(a)(35)(E)(ii); Treas. Reg. §1.401(a)(35)-1(f)(2)(ii).
7. Notice 2013-17, 2013-20 IRB 1082 (Apr. 18, 2013).
8. IRC Sec. 401(a)(35)(G)(v); Treas. Reg. §1.401(a)(35)-1(f)(5).

Employer security means a security issued by an employer of employees covered by the plan or by an affiliate of such an employer. Life insurance, health insurance, and annuity contracts are not securities for this purpose.[1]

If an employer corporation, or any member of a controlled group that includes the employer corporation, has issued a class of stock that is publicly traded, the employer may be treated as holding publicly traded employer securities even if its securities are not otherwise publicly traded. Controlled group is determined using a 50 percent test instead of an 80 percent test for this purpose.[2]

The diversification requirement does not apply to plans that meet the definition of a one-participant plan.[3] This definition has the following five criteria.

(1) On the first day of the plan year, the plan covered only one individual or that individual and his or her spouse, and the individual owns 100 percent of the plan sponsor (whether incorporated or not), or it covered only one or more partners and their spouses in the plan sponsor.

(2) It meets the minimum coverage requirements of IRC Section 410(b) (Q 3762) without being combined with any other plan of the business that covers its employees.

(3) It does not provide benefits to anyone except the individual or the partners and their spouses.

(4) It does not cover a business that is a member of an affiliated service group, a controlled group or a group of businesses under common control (Q 3830, Q 3832).

(5) It does not cover a business that uses the services of leased employees as defined in IRC Section 414(n) (Q 3826).

A partner, for purposes of this definition, also includes a 2 percent shareholder of an S corporation.[4]

ERISA applies this requirement to applicable individual account plans. An applicable individual account plan is "a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account."[5]

1. IRC Sec. 401(a)(35)(G)(iii); ERISA Sec. 407(d)(1); Treas. Reg. §1.401(a)(35)-1(f)(3).
2. IRC Sec. 401(a)(35)(F); Treas. Reg. §1.401(a)(35)-1(f)(2)(iv).
3. Treas. Reg. §1.401(a)(35)-1(f)(3)(iii).
4. IRC Sec. 401(a)(35)(E)(iv).
5. ERISA Secs. 204(j)(5), 3(34).

Pensions

3681. What is a pension plan?

A pension plan is a qualified plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits (Q 3684) to its employees over a period of years, usually for life, after retirement. A plan can meet the requirement that the benefits be definitely determinable by providing for fixed benefits or fixed contributions. Thus, a pension plan either can be a defined benefit plan or a defined contribution plan (Q 3682).

Under a plan that provides fixed benefits (a "defined benefit" plan), the amount of the pension, or a formula to determine that amount, is set in advance; an actuary determines the annual contributions that are required to accumulate a fund sufficient to provide each employee's pension when he or she retires. The size of an employee's pension is usually related to the employee's compensation, years of service, or both.

Under a plan that provides for fixed contributions (a "defined contribution" or "money purchase" plan), the annual contribution to an employee's account (rather than his or her future pension) is fixed or definitely determinable, and the employee receives whatever retirement benefit can be purchased with the funds accumulated in the employee's account. Usually the annual contribution is a fixed percentage of the employee's compensation; in any event, it must not be related to the employer's profits.[1] Contributions are not considered "fixed" where an employer intentionally overfunds a money purchase pension plan.[2]

A pension plan cannot provide regular temporary disability income or medical expense benefits (except medical expense benefits for retired employees). A pension plan may provide incidental death benefits, through life insurance or otherwise (Q 3751), and disability pensions.[3]

The employer deduction limit for pension plans is explained in Q 3731. For the minimum funding standard that applies to pension plans, see Q 3687 to Q 3691.

3682. What is a target benefit plan?

A target benefit plan is a money purchase pension plan under which contributions to an employee's account are determined by reference to the amounts necessary to fund the employee's stated benefit under the plan.[4] Consequently, allocations under a target plan are generally weighted for both age and compensation. Although a target benefit plan is a type of defined contribution plan, it is subject to certain minimum funding requirements (Q 3687 to Q 3691).

Safe harbor requirements for target plans are set forth in the cross testing regulations under IRC Section 401(a)(4), under which a target plan will be deemed to be nondiscriminatory.[5]

1. IRC Sec. 401; Treas. Reg. §1.401-1.
2. *William Bryen Co., Inc. v. Comm.*, 89 TC 689 (1987).
3. IRC Sec. 401(h); Treas. Regs. §§1.401-1(a)(2)(i), 1.401-1(b)(1)(i), 1.401-14.
4. Treas. Reg. §1.401(a)(4)-8(b)(3)(i).
5. See Treas. Reg. §1.401(a)(4)-8(b)(3).

Special rules apply to target plans for meeting the requirements of IRC Section 411(b)(2), which states that a plan may not discontinue or reduce a participant's benefit accruals or allocations because the participant reaches a particular age.[1]

3683. What is the maximum amount that an employer may deduct annually for contributions on behalf of employees to a qualified defined benefit pension plan?

The maximum annual limit on deductions by an employer, including a self-employed person, for contributions to a defined benefit pension plan is determined by an actuary who follows regulations that are structured to provide level funding over an employee's tenure with the employer. An overview of the rules that an actuary follows appears below.

(1) The employer may deduct the amount needed to fund each employee's past and current service credits distributed as a level amount or level percentage of compensation over the remaining period of his or her anticipated future service. If more than one-half of the remaining unfunded cost is attributable to three or fewer participants, the deduction of such unfunded cost for them must be spread over at least five years.[2]

(2) The employer may deduct the plan's normal cost for the year, plus an amount necessary to amortize the past service credits equally over ten years.[3] The "normal cost" is the level annual amount that would be required to fund the employee's pension from his or her date of employment to his or her retirement date.[4] The amortizable base is limited to the unfunded costs attributable to past service liability.

(3) In plan years beginning in 2006 or 2007, the employer could deduct a maximum of 150 percent of the plan's unfunded current liability for the plan year (Q 3687).[5] In the case of a plan that has 100 or fewer participants, unfunded current liability does not include liability attributable to benefit increases for highly compensated employees (Q 3827) resulting from a plan amendment that is made or that becomes effective, whichever is later, within the last two years.[6]

(4) In plan years beginning after December 31, 2007, the employer deduction may be determined by calculating the excess, if any, of (1) the funding target for the plan year plus (2) the target normal cost for the plan year and (3) a cushion amount, over (4) the value of plan assets (determined under IRC Section 430(g)(2)). The deduction limit will be the greater of this amount or the sum of the minimum required contributions under IRC Section 430 (Q 3688).[7]

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1. See Prop. Treas. Reg. §1.411(b)-2(c)(2)(iii).
2. IRC Sec. 404(a)(1)(A)(ii).
3. IRC Sec. 404(a)(1)(A)(iii); Treas. Reg. §1.412(c)(3)-1(e)(3).
4. For an illustration, see Rev. Rul. 84-62, 1984-1 CB 121.
5. See IRC Secs. 404(a)(1)(A)(i), 404(a)(1)(D).
6. IRC Sec. 404(a)(1)(D), as in effect for plan years beginning *before* January 1, 2008.
7. See IRC Sec. 404(o).

(5) A defined contribution plan that is subject to the funding standards of IRC Section 412 (e.g., a money purchase plan) is treated as a stock bonus or profit sharing plan for purposes of the deduction limits; thus, it is generally subject to a deduction limit of 25 percent of compensation.[1]

In computing the deduction for a contribution to a defined benefit plan, no benefit in excess of the Section 415 limit may be taken into consideration. Note that, similarly, in computing the deduction for a contribution to a *defined contribution plan*, the contribution taken into account must be reduced by any annual additions in excess of the Section 415 limit for the year.[2]

In determining the deductible amount, the same funding method and actuarial assumptions must be used as those that are used for the minimum funding standard.[3] The IRS has denied the deduction where it believes contributions are based on unreasonable actuarial assumptions.[4] The question of what constitutes reasonable actuarial assumptions was once the subject of extensive litigation; after a steady stream of losses in the Tax Court and federal courts, the IRS announced its concession on the issues on which it lost in those cases.[5]

In computing the deduction under (1), (2), or (3) above, a plan may not take into consideration any adjustments to the Section 415 limits before the year in which the adjustment takes effect.[6]

If the employer contributes more than the maximum deductible amount in any year, the excess amount may be carried over and deducted in succeeding years within the same limitations, even if the plan is no longer qualified in those succeeding years.[7] (See Q 3660 for an excise tax on employer contributions that exceed the deduction limits).

Note that a contribution to a *defined contribution plan* in excess of the Section 415 limits (Q 3784, Q 3677) may not be carried over and deducted in a subsequent year, even if the contribution is required under the minimum funding rules.[8]

If, in the case of a defined benefit plan, more than one plan year is associated with the taxable year of the employer due to a change in plan years, then the deductible limit for the employer's taxable year must be adjusted as described in Revenue Procedure 87-27.[9] If an employer transfers funds from one pension plan to another, the employer realizes income if the previous deduction resulted in a tax benefit.[10]

1. See IRC Sec. 404(a)(3)(A)(v).
2. IRC Sec. 404(j)(1).
3. IRC Sec. 404(a)(1)(A); Treas. Reg. §1.404(a)-14(d).
4. See TAM 9250002.
5. See IR-95-43 (June 7, 1995); *Vinson & Elkins v. Comm.*, 7 F.3d 1235 (5th Cir. 1993); *Wachtell, Lipton, Rosen & Katz v. Comm.*, 26 F.3d 291 (2d Cir. 1994).
6. IRC Sec. 404(j)(2); Treas. Reg. §1.412(c)(3)-1(d)(i).
7. IRC Secs. 404(a)(1)(E), 404(a)(2).
8. Notice 83-10, 1983-1 CB 536, F-1, F-3.
9. 1987-1 CB 769.
10. Rev. Rul. 73-528, 1973-2 CB 13.

Fully insured defined benefit pension plans. In guidance for fully insured (Section 412(i)) plans (Q 3734, Q 3735), the IRS also has stated that the portion of contributions attributable to "excess life insurance coverage" does not constitute "normal cost" and thus is not deductible.

Similarly, contributions to pay premiums for the disability waiver of premium feature with respect to such excess coverage are not deductible. Instead, such amounts are carried over to later years, although they may be subject to a nondeductible contribution penalty (Q 3840).

"Excess" coverage generally refers to contracts held on behalf of a participant whose benefit payable at normal retirement age is not equal to the amount provided at normal retirement age with respect to the contracts held on behalf of that participant, or contracts providing for a death benefit with respect to a participant in excess of the death benefit provided to that participant under that plan.[1]

3684. What special qualification requirements regarding the payment of definitely determinable benefits apply to pension plans but not to profit sharing plans?

A pension plan must provide for the payment of definitely determinable benefits to employees on retirement or over a period of years after their retirement or to their beneficiaries. Benefits must be determined without regard to the employer's profits.[2] Benefits actually payable need not be definitely determinable, provided the contributions can be determined actuarially on the basis of definitely determinable benefits. This is the theoretical basis for defined benefit plans of the "assumed benefit" or "variable benefit" type (so-called "target" plans). Benefits are "definitely determinable" under a money purchase pension plan that calls for contributions of a fixed percentage of each employee's compensation.[3]

Benefits that vary with the increase or decrease in the market value of the assets from which such benefits are payable or that vary with the fluctuations of a specified and generally recognized cost-of-living index are consistent with a plan providing for definitely determinable benefits.[4] A plan provides a definitely determinable benefit if, in the case of an insured plan, the practice of the insurer is to provide a retirement annuity that is the higher of an annuity bought at an annuity rate guaranteed in the contract surrendered in exchange for the same type of annuity purchased at current annuity rates.[5]

The IRS determined that a governmental cash balance plan in which the interest rate credited on contributions was set by a board appointed under state law nonetheless provided a definitely determinable benefit.[6]

1. See Rev. Rul. 2004-20, 2004-10 IRB 546.
2. Treas. Regs. §§1.401-1(a)(2)(i), 1.401-1(b)(1)(i).
3. Treas. Reg. §1.401-1(b)(1)(i).
4. Rev. Rul. 185, 1953-2 CB 202.
5. Rev. Rul. 78-56, 1978-1 CB 116.
6. Let. Rul. 9645031.

To be definitely determinable, a plan that credits interest must specify how the plan determines interest and must specify how and when interest is credited. Interest must be credited at least annually.

Regulations specify two methods that a plan can use to determine the plan's interest crediting rate: the applicable periodic interest crediting rate that applies over the current period or the rate that applied in a specified lookback month with respect to a stability period.[1]

A defined benefit plan will not be treated as providing definitely determinable benefits unless the actuarial assumptions used to determine the amount of any benefit (including any optional or early retirement benefit) are specified in the plan in a way that precludes employer discretion.[2]

Under certain plans, a participant receives not only a defined benefit specified in the plan but also amounts that have been credited to individual accounts each year based on excess earnings; in other words, actual trust earnings in excess of the investment yield assumption used in the valuation of the cost of providing the defined benefit (an excess earnings plan). Where contributions to these plans are discretionary, the amount of excess interest allocations to the defined contribution portion of the plan is not definitely determinable, and the plan will not qualify.[3]

Retirement benefits are not definitely determinable under a plan that permits the withdrawal of employer contributions. Hence, a pension plan may not permit the withdrawal of employer contributions or earnings thereon, even in the case of financial need, before death, retirement, disability, severance of employment, or termination of the plan.[4] Withdrawals may be made once the employee has reached normal retirement age even if the employee has not actually retired.[5]

A pension plan may permit withdrawal of all or part of an employee's own contributions plus interest actually earned thereon when the employee discontinues participation in the plan, even though the employee continues to work for the employer.[6]

In addition, a pension plan may permit an employee to withdraw his or her nondeductible voluntary contributions without terminating his or her participation in the plan, provided the withdrawal will not affect the employee's participation in the plan, the employer's past or future contributions on his or her behalf, or the basic benefits provided by both the employee's and the employer's compulsory contributions, and no interest is allowable with respect to the contributions withdrawn either at the time of withdrawal or in computing benefits at retirement.[7]

The IRS takes the position that all benefits payable under a plan, including early retirement, disability pension, and preretirement death benefits, must be definitely determinable.

1. Treas. Regs. §1.411(b)(5)-1.
2. IRC Sec. 401(a)(25); Rev. Rul. 79-90, 1979-1 CB 155.
3. Rev. Rul. 78-403, 1978-2 CB 153.
4. Rev. Rul. 69-277, 1969-1 CB 116; Rev. Rul. 74-417, 1974-2 CB 131.
5. Rev. Rul. 71-24, 1971-1 CB 114; Rev. Rul. 73-448, 1973-2 CB 136, superseded by GCM 38002 which republished Rev. Rul. 73-448.
6. Rev. Rul. 60-281, 1960-2 CB 146.
7. Rev. Rul. 60-323, 1960-2 CB 148; Rev. Rul. 69-277, 1969-1 CB 116.

Thus, a pension plan funded by a combination of life insurance and an auxiliary fund, which provided a pension on early retirement or disability, the amount of which was based in part on the participant's interest in the auxiliary fund, failed to qualify because the employer was not required to maintain the fund at a particular level or to make contributions at any particular time.[1]

Similarly, a defined benefit pension plan that provided a preretirement death benefit equal to the amount of the pension benefit funded for a participant as of the date of the participant's death failed to qualify.[2]

Likewise, a change in actuarial factors that affects the calculation of a participant's optional or early retirement benefit would result in plan disqualification.[3]

Benefits under a defined benefit plan will be considered definitely determinable even if they are offset by benefits provided by a profit sharing plan, if determination of the amount of the offset is not subject to the employer's discretion. The actuarial basis and the time for determining the offset must be specified in the defined benefit plan to preclude employer discretion.[4]

Pension benefits will not fail to be definitely determinable because a factor or condition, determinable only after retirement, is used to compute benefits in accordance with an express provision in the plan if the factor or condition is not subject to the discretion of the employer.[5]

Forfeitures

Related to the definitely determinable benefits rule is the requirement that a pension plan provide that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan.[6]

3685. What special qualification requirements regarding retirement age apply to pension plans but not to profit sharing plans?

Pension and annuity plans are retirement plans; thus, they must be established primarily to provide definitely determinable benefits at normal retirement age.

The normal retirement age in a pension or annuity plan is the lowest age specified in the plan at which the employee has the right to retire without the consent of the employer and receive retirement benefits based on service to date of retirement at the full rate set forth in the plan (i.e., without actuarial or similar reduction because of retirement before some later specified age). Normal retirement age must be an age that is not earlier than the earliest age

1. Rev. Rul. 69-427, 1969-2 CB 87.
2. Rev. Rul. 72-97, 1972-1 CB 106.
3. Rev. Rul. 81-12, 1981-1 CB 228.
4. Rev. Rul. 76-259, 1976-2 CB 111.
5. Rev. Rul. 80-122, 1980-1 CB 84.
6. IRC Sec. 401(a)(8).

that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.[1] The following table describes the standard by which the IRS will determine whether a normal retirement age is reasonable:

Normal Retirement Age	Standard Applied
62 or above	Deemed reasonable
Between ages 55 and 62	Depends on facts and circumstances or workforce
Under age 55	Deemed unreasonable unless Commission determines otherwise
Age 50 and later	Reasonable, if substantially all of participants are public safety workers[2]

The IRS has announced its intention to modify this rule to eliminate the requirement that substantially all of the public safety workers be covered by a separate plan.[3]

The IRS plans to modify the normal retirement regulations to clarify that governmental plans that do not permit in-service distributions before age sixty-two are not required to include a definition of normal retirement age in the plan.[4]

If normal retirement age is less than age sixty-two and benefits begin before that age, the defined benefit dollar limit must be actuarially reduced for purposes of the Section 415 limits on benefits (Q 3677, Q 3784).[5]

The IRC also requires that the accrued benefit of an employee who retires after age 70½ be actuarially increased to take into account any period after age 70½ in which the employee was not receiving any benefits under the plan.[6] Guidance for implementing this requirement is set forth in regulations finalized in 2004 (Q 3805).[7]

An actuarial assumption that employees will retire at a normal retirement age specified in the plan that is a lower age than they normally retire could result in computation of amounts that are not currently deductible if the assumption causes the actuarial assumptions in the aggregate to be unreasonable.[8] The IRS has challenged the use of normal retirement ages under age sixty-five in small defined benefit plans (i.e., plans covering from one to five employees) (Q 3683). A pension plan may permit early retirement, and any reasonable optional early retirement age generally will be acceptable.

1. Treas. Reg. 1.401(a)-1(b)(2).
2. Treas. Reg. 1.401(a)-1(b)(2).
3. Notice 2012-29, 2012 IRB 872.
4. Treas. Reg. 1.401(a)-1(b)(2).
5. IRC Sec. 415(b)(2)(C).
6. IRC Sec. 401(a)(9)(C)(ii).
7. Treas. Reg. §1.401(a)(9)-6, A-7.
8. Rev. Rul. 78-331, 1978-2 CB 158.

3686. Can a pension plan allow participants to retire in phases and still remain qualified?

In plan years beginning after December 31, 2006, a pension will not fail to be qualified solely because it permits distributions to be made to an employee who has attained age sixty-two and has not separated from employment at the time of the distribution.[1]

In addition, proposed regulations addressing phased retirement were issued in late 2004, setting forth provisions that would allow pension plan participants other than key employees (Q 3828) at least 59½ years of age to voluntarily reduce their hours (at least 20 percent) and receive a pro rata portion of their pension annuity. Under the proposal, all early retirement benefits, retirement type subsidies, and optional forms of benefit available on full retirement would have to be offered in the event of a phased retirement, except that payment could not be made in the form of a single-sum distribution or other eligible rollover distribution. An employee engaged in phased retirement essentially would have a "dual status." The employee would remain an employee for purposes of plan participation, with full-time status imputed, except for the proportionate reduction in compensation for the lower number of hours worked, but the employee would receive a portion of his or her pension annuity corresponding to the reduction in his or her hours.

The phased retirement regulations do not take effect and may not be relied on until they are finalized.[2] Earlier rulings supported the determination that a plan could provide for a lump sum distribution to an employee who has reached both 59½ and normal retirement age, even if the employee continued to work for the employer.[3]

A pension plan may provide for payment of the balance to the credit of an employee on plan termination.[4] A plan that permits an employee to elect death benefits to the exclusion of retirement benefits will not qualify.[5] This rule does not prevent a plan from providing "incidental" death benefits (Q 3751, Q 3813).

Minimum Funding Standard

3687. What is the minimum funding standard that applied in plan years before 2008?

The Pension Protection Act of 2006 replaced the minimum funding standard with a single minimum required contribution (Q 3688). The Act's funding provisions generally take effect for plan years beginning after 2007. For plan years beginning before 2008, the IRC provided for a minimum funding standard requiring at least a minimum level of funding for qualified defined benefit plans. A second "deficit reduction contribution" applied in the case of certain plans with over 100 participants.

1. IRC Sec. 401(a)(36); Notice 2007-8; 2007-1 C.B. 276.
2. See REG-114726-04, 69 Fed. Reg. 65108 (Nov. 10, 2004); Prop. Treas. Reg. §§1.401(a)-3.
3. Special ruling, 10-29-76; Let. Rul. 7740031.
4. IRC Sec. 401(a)(20).
5. Rev. Rul. 56-656, 1956-2 CB 280.

The minimum amount that an employer is required to contribute to fund a money purchase pension plan (both before and after PPA 2006) is the contribution amount required under the terms of the plan for each year, as stated in the plan formula.[1]

Profit sharing and stock bonus plans (Q 3694 to Q 3738), certain government and church plans, certain employee-pay-all plans, and fully insured plans (known as 412(i) plans) (Q 3735) are exempt from the minimum funding requirements, both before and after the Act.[2]

The minimum funding requirements are not qualification requirements (Q 4647).[3] Waiver of the minimum funding standard because of hardship may be available in some circumstances (Q 3692).[4]

Under the minimum funding standard, the employer must contribute at least a minimum amount to its qualified defined benefit, money purchase pension, or annuity plan.[5]

To determine its minimum contribution, an employer must establish a separate funding standard account for each separate plan.[6] A plan that has a funding method requiring contributions at least equal to those required under the entry age normal cost method also may maintain an alternative minimum funding standard account.[7]

Under the regular funding rules, the funding standard account (and the alternative account, if one is maintained) is to be charged with certain liabilities and credited with certain amounts each plan year. If the charges to the funding standard account for all plan years beginning after the standard is first applicable to the plan exceed the credits (or, if less, the excess of the charges to the alternative minimum funding standard account for the same years over the credits), the plan has an "accumulated funding deficiency" to the extent of the excess. The minimum funding standard is satisfied when there is no accumulated funding deficiency; that is, when the balance in the funding standard account (or the alternative minimum funding standard account) at the end of the year is zero.[8]

Charges

The liabilities that must be currently funded and charged to the funding standard account under the regular funding rules are the "normal cost" (the level annual amount that would be required to fund the employee's pension from his date of employment to his retirement), and the amounts required to amortize, in equal installments, until fully amortized,

(1) the unfunded past service liability that existed on the first day the section applied to the plan over a period of thirty years (forty years if the plan was in existence on January 1, 1974);

1. See IRC Sec. 412(a)(2)(B).
2. IRC Sec. 412(e)(2).
3. See *Anthes v. Comm.*, 81 TC 1 (1983), *aff'd*, 740 F.2d 953 (1st Cir. 1984).
4. IRC Sec. 412(c)(2).
5. See IRC Sec. 412, prior to amendment by PPA 2006.
6. IRC Sec. 412(b).
7. IRC Sec. 412(g).
8. IRC Sec. 412(a).

(2) any net increase in unfunded past service liability because of plan amendments in the year over a period of thirty years;

(3) any net experience loss over a period of five years (fifteen years if a multiemployer plan);

(4) any net loss from changes in actuarial assumptions over a period of ten years (thirty years if a multiemployer plan);

(5) each previously waived funding deficiency over a period of five years (fifteen years if a multiemployer plan); and

(6) any amount previously credited to the account as a result of using the alternative minimum funding standard account as the funding standard over a period of five years.[1]

Employers generally must amortize the amount that they would have been required to contribute, but for the increase, over twenty years (Q 3673).[2] Special rules apply to funding methods that do not provide for amortization bases.[3]

Credits

Amounts that are credited to the funding standard account under the regular funding rules include:

(1) employer contributions;

(2) amounts necessary to amortize, in equal installments (1) any net decrease in unfunded past service liability arising from amendments over a period of thirty years, (2) any net experience gain over a period of five years (fifteen years if a multiemployer plan), and (3) any gain from changes in actuarial assumptions over a period of ten years (thirty years if a multiemployer plan);

(3) the amount of the funding standard that has been waived by the Secretary of Treasury because of substantial business hardship; and

(4) an adjustment, if the alternative minimum funding standard was used in a previous year.[4]

Amortization periods may be longer in certain circumstances.[5]

Guidelines for determining experience gains and losses are set forth in Revenue Ruling 81-213.[6] Dividends, rate credits, and forfeitures are treated as experience gains if (1) the plan is funded solely through a group deferred annuity contract, (2) the annual single premium is treated as the normal cost, and (3) an amount necessary to pay, in equal annual installments

1. See IRC Sec. 412(b)(2).
2. IRC Sec. 412(b)(2)(E).
3. Rev. Rul. 2000-20, 2000-1 CB 880.
4. IRC Sec. 412(b)(3).
5. See IRC Secs. 412(e), 412(b)(6).
6. 1981-2 CB 101.

over the amortization period, the single premium necessary to provide all past service benefits not initially funded, is treated as the annual amortization amount.[1]

Alternative Minimum Funding Standard Account

The alternative minimum funding standard account is charged only with the lesser of (1) normal cost under the plan's funding method or under the unit credit method, any excess of the value of accrued benefits over the fair market value of plan assets, and any excess of credits over charges to the account in all prior years. The alternative funding standard account is credited with the employer's contribution and is also charged or credited with interest.[2]

Interest

The funding standard account also is charged or credited with interest at a rate consistent with that used to determine plan costs. For plan years beginning in 2006 and 2007, the interest rate is based on a yield curve derived from a two year weighted average of interest rates on investment grade corporate bonds. This amendment extends the relief implemented by PFEA 2004.[3]

Deficit Reduction Contributions

An additional charge to the funding standard account (and, thus, an increased contribution) is required for certain defined benefit plans (other than multiemployer plans) that have more than 100 participants and have a funded current liability percentage for any plan year below certain limits.[4] Relief from this requirement is available for certain airlines and steel manufacturers.[5]

3688. What is the funding requirement for defined benefit plans beginning after 2007?

The Pension Protection Act of 2006 replaces the minimum funding standard account and the deficit reduction contribution for single-employer defined benefit plans (Q 3687) with a single basic "minimum required contribution."[6]

The minimum required contribution for a defined benefit plan (other than multiemployer plans) is determined in the following manner:

(1) If the value of a plan's assets (reduced as described below) equals or exceeds the funding target of the plan for the plan year, the minimum required contribution is the target normal cost reduced (but not below zero) by such excess.[7]

(2) If the value of the plan's assets (reduced as described below) is less than the funding target of the plan for the plan year, the minimum required contribution is the sum

1. Treas. Reg. §1.412(b)-2.
2. IRC Sec. 412(g)(2); Prop. Treas. Reg. §1.412(g)-1.
3. See IRC Sec. 412(b)(5); see also IRC Sec. 412(l)(7)(C)(i)(IV); Notice 2004-34, 2004-18 IRB 848; Notice 2013-2, 2013 IRB LEXIS 32.
4. See IRC Secs. 412(l)(1), 412(l)(6).
5. See 412(i)(12).
6. IRC Sec. 412(a)(2)(A), 430.
7. IRC Sec. 430(a)(2).

of: (a) the target normal cost, (b) the shortfall amortization charge (if any) for the plan for the plan year, and (c) the waiver amortization charge (if any) for the plan for the plan year.[1]

Target Normal Cost. With the exception of plans in "at-risk" status (Q 3689), a plan's target normal cost means the present value of all benefits that are expected to accrue or to be earned under the plan during the plan year. If any benefit attributable to services performed in a preceding plan year is increased by reason of any increase in compensation during the current plan year, the benefit increase will be treated as having accrued during the current plan year.[2]

Shortfall Amortization Charge. The shortfall amortization charge for a plan for any plan year is the aggregate total (not below zero) of the shortfall amortization installments for the plan year with respect to any shortfall amortization base that has not been fully amortized.[3] The shortfall amortization installments are the amounts necessary to amortize the shortfall amortization base of the plan for any plan year in level annual installments over the seven-plan-year period beginning with such plan year.[4] For this purpose, the use of segmented interest rates derived from a yield curve will be phased in under rules set forth in IRC Section 430(h)(2)(C).

The shortfall amortization base for a plan year is the funding shortfall (if any) of the plan for that plan year, minus the present value of the total of the shortfall amortization installments and waiver amortization installments that have been determined for the plan year and any succeeding plan year with respect to the shortfall amortization bases and waiver amortization bases of the plan for any previous plan year.[5]

The funding shortfall of a plan for any plan year is the excess (if any) of the funding target for the plan year over the value of the plan assets (reduced as described below) for the plan year that are held by the plan on the valuation date.[6] If the value of a plan's assets (reduced as described below) is equal to or greater than the funding target of the plan for the plan year, the shortfall amortization base of the plan for the plan year is zero.[7]

Under special transition rules, the determination of the funding shortfall for certain plans could be calculated using only an applicable percentage of the funding target, as follows:

Plan year beginning in calendar year	The applicable percentage is
2008	92
2009	94
2010	96

1. IRC Sec. 430(a)(1).
2. IRC Sec. 430(b).
3. IRC Sec. 430(c)(1).
4. IRC Sec. 430(c)(2).
5. IRC Sec. 430(c)(3).
6. IRC Sec. 430(c)(5).
7. IRC Sec. 430(c)(5)(A).

This phase-in transition relief was available only to plans for which the shortfall amortization base for each of the plan years beginning after 2007 was zero. The transition relief was unavailable for plans that were not in effect for a plan year beginning in 2007.[1]

Waiver amortization charge. The waiver amortization charge (if any) for the plan year is the total of the plan's waiver amortization installments for the plan year with respect to the waiver amortization bases for each of the five preceding plan years.[2] The waiver amortization installments are the amounts necessary to amortize the waiver amortization base of the plan for any plan year in level annual installments over a period of five plan years, beginning with the succeeding plan year. The waiver amortization installment for any plan year in this five year period with respect to any waiver amortization base is the annual installment determined for that year for that base.[3]

Reduction of plan asset values. In the case of a plan that maintains a prefunding balance or a funding standard carryover balance, the amount that is treated as the value of plan assets is subject to reduction for purposes of determining the minimum required contribution and any excess assets, funding shortfall, and funding target attainment percentage. The value of plan assets is deemed to be that amount reduced by the amount of the prefunding balance, but only if the employer has elected to apply a portion of the prefunding balance to reduce the minimum required contribution for the plan year. In turn, this affects the availability of transition relief described above.[4]

To address the hardship produced by the PPA funding requirements in an economic downturn, the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 allows a plan sponsor to elect one of two alternative extensions of the seven year period otherwise required for amortizing the shortfall amortization base. Special rules also may apply with respect to alternate required installments in cases of excess compensation or extraordinary dividends or stock redemptions.[5]

The extension is available until the latest of 1) the last day of the first plan year beginning on or after January 1, 2013, 2) the last day of the plan year for which Section 436 is effective, or 3) the due date (including extensions) of the employer's tax return for the tax year that contains the first day of the plan year for which Section 436 is first effective for the plan.[6]

Plan sponsors that elect the extension must give notice to participants and beneficiaries and must notify the PBGC of the election.[7]

3689. What requirements apply to defined benefit plans that are "at risk" beginning after 2007?

In plan years beginning after December 31, 2007, a defined benefit plan with more than 500 participants (determined on a controlled group basis) will be considered "at-risk" if the

1. IRC Sec. 430(c)(5)(B).
2. IRC Sec. 430(e).
3. IRC Sec. 430(e)(2).
4. IRC Sec. 430(f)(4); Treas. Reg. §1.430(i)-1(e).
5. IRC Sec. 430(c)(7); Notice 2011-3, 2011-2 IRB 263.
6. Notice 2011-96, 2011-52 IRB 915; Notice 2012-70, 2012-51 IRB 712.
7. Notice 2011-3, 2011-2 IRB 263, at N.

funding target attainment percentage determined under IRC Section 430 (Q 3688), but without regard to the at-risk rules, is less than 80 percent and the funding target attainment percentage for the preceding plan year determined under IRC Section 430 and using the more aggressive assumptions described below to compute the funding target, is less than 70 percent.[1]

Under transition rules, the 80 percent funding target attainment percentage is reduced to 65 percent in 2008, 70 percent in 2009, and 75 percent in 2010. For plan years beginning in 2008, the determination of the 70 percent threshold for the preceding year may be estimated under guidance to be provided.[2]

If a plan is "at risk" for a plan year, its funding target is the present value of all the benefits accrued or earned under the plan as of the beginning of the plan year, using more aggressive actuarial assumptions, as follows: (1) all employees who are not otherwise assumed to retire as of the valuation date, but who will be eligible to elect benefits during the plan year and the ten succeeding plan years, will be assumed to retire at the earliest retirement date under the plan year after the end of the year for which the at-risk funding target and target normal cost are being determined, and (2) all employees will be assumed to elect the retirement benefit with the highest present value of benefits at the assumed retirement age determined in (1).[3]

In addition, plans that have been at-risk for at least two of the preceding four years will be subject to a loading factor.[4] The loading factor is $700 times the number of participants in the plan, plus 4 percent of the funding target, determined without regard to this provision, of the plan for the plan year.[5]

At-risk plans also may be subject to a qualification requirement that suspends many benefit increases, plan amendments, and accruals in single-employer plans when funding falls below specified levels ranging from 60 percent to 80 percent (Q 3667).[6]

3690. When are pension plan contributions credited for funding standard account purposes?

For plan years beginning before 2008, the funding standard account is credited with the contributions for the plan year.[7] The employer had a grace period of 8½ months after the plan year ended to make contributions for that plan year.[8] This is true even with respect to the plan year in which the plan terminates.[9]

A contribution was not considered timely made when, prior to the expiration of the 8½ months an employer merely segregated a sum sufficient to fund its plan contributions in an extra checking account in the name of the employer, not in the name of the plan.[10]

1. IRC Secs. 430(i)(4)(A), 430(i)(6).
2. IRC Sec. 430(i)(4)(B); Treas. Reg. §1.430(i)-1.
3. IRC Sec. 430(i)(1).
4. IRC Sec. 430(i)(1)(A)(ii).
5. IRC Sec. 430(i)(1)(C).
6. See IRC Sec. 436.
7. IRC Sec. 412(b)(3)(A), prior to amendment by PPA 2006.
8. IRC Sec. 412(c)(10), prior to amendment by PPA 2006; Temp. Treas. Reg. §11.412(c)-12(b).
9. Rev. Rul. 79-237, 1979-2 CB 190, *as modified by* Rev. Rul. 89-87, 1989-2 CB 81.
10. *D. J. Lee, M.D., Inc. v. Comm.*, 92 TC 291 (1989), *aff'd on other grounds*, 91-1 USTC 87,881 (6th Cir. 1991).

The rules governing the time when a contribution is deemed made for the purposes of crediting the funding standard account generally are independent of the rules governing the time when a contribution is deemed made for deduction purposes.[1] Thus, contributions made for one plan year but carried over to a later tax year for deduction purposes may not be credited to the account as a contribution for the later year.[2] A contribution made during the grace period on account of the preceding tax year may be made for and credited to the account for the current plan year.[3] Likewise, a contribution made in and deducted for the current plan year may be credited for the previous year for purposes of the funding rules if made during the grace period.[4]

3691. What other special requirements apply in plan years prior to 2008 when a qualified plan is subject to the minimum funding standard?

Under the full funding limitation, a plan generally must fund for certain expected increases due to benefits accruing during the plan year.[5] Any resulting increase in unfunded liability must be amortized over thirty years. Although a change in benefit provisions of a plan may not be assumed under a reasonable funding method, future salary may be assumed to change without being considered a benefit change. Thus, funding must be based on projected benefits reflecting expected salary history, but only to the extent that the projected benefits do not exceed the maximum benefit permitted under the current plan provisions. For example, funding for a benefit of 90 percent of the participant's salary for his or her high three consecutive years may be based on 90 percent of the participant's projected salary, but not in excess of the maximum dollar benefit provided under the plan for the current year.[6]

Experience gains and losses are to be determined and plan liability valued at least once a year.[7] Normal costs, accrued liabilities, and experience gains and losses are to be determined under the funding method used to determine costs under the plan. Plan assets are to be valued by any reasonable actuarial method that takes into account fair market value and is permitted under regulations.[8] Asset valuations may not be based on a range of 85 percent to 115 percent of average value.[9]

Ordinarily, the annual valuation must be made during the plan year or within one month prior to the beginning of the plan year. A valuation date from the immediately preceding plan year may be used provided that, as of that date, the plan assets are not less than 100 percent of the plan's current liability.[10] A change to a prior year valuation may not be made unless plan assets are not less than 125 percent of the plan's current liability.[11]

1. Temp. Treas. Reg. §11.412(c)-12(b)(2); Prop. Treas. Reg. §1.412(c)(10)-1(c).
2. Rev. Rul. 77-151, 1977-1 CB 121.
3. Rev. Rul. 77-82, 1977-1 CB 121.
4. Let. Rul. 9107033.
5. See IRC Sec. 412(c)(7)(E)(i)(I).
6. Rev. Rul. 81-195, 1981-2 CB 104.
7. IRC Sec. 412(c)(9).
8. See Treas. Reg. §1.412(c)(2)-1(b)(6).
9. OBRA '87, Sec. 9303(c).
10. IRC Sec. 412(c)(9)(B).
11. IRC Section 412(c)(9)(B)(iv).

Each actuarial assumption must be reasonable or, when aggregated, result in a total contribution equal to the amount that would be determined if each were reasonable. In the case of multiemployer plans, actuarial assumptions only need be reasonable in the aggregate. Of course, all actuarial assumptions must offer the actuary's best estimate of anticipated experience.[1]

Automatic approval is available for certain changes in a plan's funding method. Examples of such changes include approvals:

(1) to remedy unreasonable allocation of costs,

(2) for fully funded terminated plans,

(3) for takeover plans,

(4) for changes in valuation software,

(5) for *de minimis* mergers,

(6) for certain mergers with the same plan year and a merger date of first or last day of plan year, and

(7) for certain mergers involving a designated transition period.[2]

Defined benefit pension plans generally are not permitted to anticipate amendments (even if adopted within the remedial amendment period) in determining funding, except as specifically required by IRC Section 412(c)(12).[3]

For a multiemployer plan maintained pursuant to a collective bargaining agreement, the minimum funding standard is determined as if all participants in the plan were employed by a single employer.[4] Projected benefit increases scheduled to take effect during the term of the agreement must be taken into account.[5] In contrast, each employer in a multiple employer plan generally is treated as maintaining a separate plan for purposes of the minimum funding rules, unless the plan uses a method for determining required contributions under which each employer contributes at least the amount that would be required if each employer maintained a separate plan.[6]

If the employer maintaining the plan is a member of a group treated as a single employer under the controlled group, common control, or affiliated service provisions (Q 3830, Q 3832), then each member of the group is jointly and severally liable for the amount of any contributions required under the minimum funding standard or the amount of any required installments to the plan.[7]

1. IRC Sec. 412(c)(3).
2. See Rev. Proc. 2000-40, 2000-2 CB 357.
3. Rev. Proc. 98-42, 1998-2 CB 55.
4. IRC Sec. 413(b)(5).
5. IRC Sec. 412(c)(12).
6. IRC Sec. 413(c)(4).
7. IRC Sec. 412(c)(11).

The minimum funding standard continues to apply even if the plan later becomes nonqualified. It does not apply in years after the end of the plan year in which the plan terminates completely. For guidelines as to the application of the minimum funding standard to the plan year in which a plan terminates, see Revenue Ruling 89-87[1] and Proposed Treasury Regulation §1.412(b)-4. The minimum funding standard must be re-established if the terminated plan is restored to the sponsoring employer by the PBGC.[2]

3692. What is the penalty for underfunding a qualified plan that is subject to the minimum funding standard?

If a plan subject to the minimum funding standard (Q 3687 to Q 3691) fails to meet it, the employer sponsoring the plan is penalized by an excise tax, but the plan will not be disqualified.[3] Imposition of the tax is automatic; there is no exception for unintentionally or inadvertently failing to meet the standard or for having intended to terminate the plan.[4]

For a single employer plan, the tax is 10 percent of the aggregate unpaid minimum required contributions for all plan years (Q 3687 to Q 3691) remaining unpaid as of the end of any plan year ending with or within the taxable year.[5] (In the case of a multiemployer plan, the tax is 5 percent of any accumulated funding deficiency.) In one case, an employer was liable for the 10 percent tax where a contribution was made on time according to the terms of the plan, but not within the period specified in IRC Section 412.[6]

If the 10 percent tax is imposed on any unpaid minimum required contributions and if it remains unpaid as of the close of the taxable period, or if the 10 percent tax is imposed on a multiemployer plan's accumulated funding deficiency, an additional tax of 100 percent will be imposed on the employer to the extent that the minimum required contribution or accumulated funding deficiency is not corrected within the taxable period.[7] This additional 100 percent tax will be abated if the deficiency is corrected within ninety days after the date when the notice of deficiency is mailed. This period may be extended by the Secretary of the Treasury.[8]

An additional tax is applied to certain defined benefit plans with a funded current liability percentage of less than 100 percent that have a "liquidity shortfall" for any quarter during a plan year.[9] Such a plan may be subject to a tax of 10 percent of the excess of the amount of the liquidity shortfall for any quarter over the amount of such shortfall paid by the required installment for the quarter.[10] If the shortfall was due to reasonable cause and not willful neglect, and if

1. 1989-2 CB 81.
2. See Treas. Reg. §1.412(c)(1)-3, TD 8494, 1993-2 CB 203.
3. TIR 1334 (1/8/75), M-5.
4. See *D.J. Lee, M.D., Inc. v. Comm.*, 931 F. 2d 418, 91-1 USTC ¶50,218 (6th Cir. 1991); *Lee Eng'g Supply Co., Inc. v. Comm.*, 101 TC 189 (1993).
5. IRC Sec. 4971(a).
6. *Wenger v. Comm.*, TC Memo 2000-156.
7. IRC Sec. 4971(b).
8. IRC Secs. 4961, 4963(e).
9. IRC Secs. 4971(f), 430(j).
10. IRC Sec. 4971(f).

reasonable steps have been taken to remedy the liquidity shortfall, the Secretary of the Treasury has the discretion to waive part or all of the penalty.[1]

An uncorrected deficiency will continue in later years and will be increased by interest charges until it is paid.[2] When an employer fails to contribute a plan's normal cost in any year, that amount will not, thereafter, become a past service cost to be amortized. The funding standard account will show the amount as a deficiency subject to tax each year until corrected.

If the employer is a member of a group that is treated as a single employer under the controlled group, common control, or affiliated services group provisions (Q 3830, Q 3832), then each member of the group is jointly and severally liable for any tax payable under IRC Section 4971.[3] The tax is due for the tax year in which (or with which) the plan year ends. The IRS has determined that general partners were jointly and severally liable for a partnership's excise tax obligation resulting from failure to satisfy the minimum funding standard.[4]

Where a plan chooses to keep both a funding standard account and an alternative minimum funding standard account, the tax will be based on the lower minimum funding requirement.[5]

None of the excise taxes payable under IRC Section 4971 are deductible.[6]

If a plan is maintained pursuant to a collective bargaining agreement or by more than one employer, the liability of each employer will be based first on the employers' respective delinquencies in meeting their required contributions, and then on the basis of the employers' respective liabilities for contributions.[7]

The tax does not apply in years after the end of the plan year in which the plan terminates. If the accumulated funding deficiency has not been reduced to zero as of the end of that plan year, then the 100 percent tax is due for the plan year in which the plan terminates.[8]

For further guidance on the tax penalty for underfunding, see Treasury Regulation Section 54.4971-1 and Proposed Treasury Regulation Sections 54.4971-2 to 54.4971-3.

3693. Can the minimum funding standard for qualified plans be waived?

Under limited circumstances, the IRS may grant a waiver of the minimum funding standard. To obtain such a waiver, the employer sponsoring the plan must demonstrate that imposition of the 100 percent tax would be a substantial business hardship and adverse to the interest of plan participants in the aggregate.[9] Updated procedures for requesting a waiver of the 100 percent

1. IRC Sec. 4971(f)(4).
2. See IRC Sec. 412(b)(5).
3. IRC Sec. 4971(e).
4. Let. Rul. 9414001.
5. IRC Secs. 4971(c)(1), 412(a).
6. IRC Sec. 275(a)(6).
7. IRC Secs. 413(b)(6), 413(c)(5).
8. Rev. Rul. 79-237, 1979-2 CB 190, *as modified by* Rev. Rul. 89-87, 1989-2 CB 81.
9. See IRC Sec. 412(d).

tax are set forth in Revenue Procedure 2004-15.[1] The IRS may grant a waiver contingent on certain conditions being met; if they are not met, the waiver is void retroactively. An employer sponsoring a plan may request a modification of a conditional waiver of the minimum funding requirements by private letter ruling request.[2] The IRS has privately ruled that waiver is appropriate where the hardship is likely to be temporary,[3] but not where the hardship is of a permanent nature.[4] Under certain circumstances, the IRS may approve a retroactive plan amendment reducing plan liabilities due to substantial business hardship.[5]

Employers sponsoring certain terminated single-employer defined benefit plans may obtain a waiver of the 100 percent tax imposed on an accumulated funding deficiency. To obtain the waiver, these conditions must be met:

(1) the plan must be subject to Title IV of ERISA,

(2) the plan must be terminated in a standard termination under ERISA Section 4041,

(3) plan participants must not be entitled to any portion of residual assets remaining after all liabilities of the plan to participants and their beneficiaries have been satisfied,

(4) excise taxes that have been (or could be) imposed under IRC Section 4971(a) must have been paid for all taxable years (including the taxable year related to the year of plan termination), and

(5) the plan must have filed all applicable forms in the 5500 series (including Schedule B) for all plan years (including the year of plan termination).[6]

Profit Sharing Plans

3694. What is a profit sharing plan?

A profit sharing plan is a plan for sharing company profits with employees. A profit sharing plan need not provide a definite, predetermined formula for determining the amount of profits to be shared. In the absence of a definite formula, there must be recurring and substantial contributions, and contributions must not be made at such times and in such amounts that the plan in operation discriminates in favor of highly compensated employees.[7] A profit sharing plan may explicitly provide for investment primarily in qualifying employer securities (Q 3740).[8]

1. 2004-7 IRB 490. See, e.g., Let. Ruls. 200349005, 9849024.
2. See, e.g., Let. Ruls. 9852051, 9849031.
3. Let Rul. 9846047.
4. Let. Rul. 9846049.
5. See Let. Rul. 9736044.
6. See Rev. Proc. 2000-17, 2000-1 CB 766.
7. Treas. Reg. §1.401-1(b)(1)(ii).
8. ERISA Secs. 407(b)(1), 407(d)(3).

For an explanation of specific qualification requirements applicable to profit sharing plans, see Q 3696. There are qualification requirements that apply to 401(k) plans (Q 3697 to Q 3733) and an employer deduction limit for profit sharing contributions (Q 3695).

A profit sharing plan must provide a definite, predetermined formula for allocating contributions among participants and for distributing accumulated funds to the employees after a fixed number of years (at least two), the attainment of a stated age, or on prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. The allocation formula generally is related to compensation, although age, service, and other factors may be given consideration (Q 3778). A profit sharing plan cannot provide for allocations or distributions based on predetermined benefits, because such a plan would be a pension plan. Although a profit sharing plan is primarily a plan of deferred compensation, the plan may use funds in an employee's account to provide incidental life or health insurance for the employee or the employee's family (Q 3751).[1]

A tax-exempt "non-profit" charitable organization may maintain a profit sharing plan, including a 401(k) plan.[2]

3695. How much may an employer deduct for its contributions to a qualified profit sharing or stock bonus plan?

An employer's deduction for contributions to a profit sharing or stock bonus plan is the greater of (1) 25 percent of the compensation otherwise paid or accrued during the employer's taxable year to the beneficiaries of the plan, or (2) the amount the employer is required to contribute under Section 401(k) for the year.[3]

The amount of annual compensation of each employee taken into account for purposes of this limitation may not exceed $260,000 (in 2014, as indexed. The amount was $255,000 in 2013).[4] Compensation for this purpose is Section 415(c)(3) compensation, which includes elective deferrals under 401(k) and Section 457 plans, salary reduction contributions to Section 125 cafeteria plans, and qualified transportation fringe benefits under IRC Section 132(f).[5] In the case of a self-employed person, "earned income" is used instead of "compensation" (Q 3749).

Contributions, for purposes of the deduction limit, do not include elective deferrals (Q 3705), and elective deferrals are not themselves subject to any limitation contained in IRC Section 404.[6]

Contributions allocated to life and health insurance is included in the 25 percent limit. A terminating employee's compensation for the final year is included in the 25 percent only if

1. Treas. Reg. §1.401-1(b)(1)(ii).
2. IRC Sec. 401(k)(4)(B)(i); GCM 38283 (2-15-80).
3. IRC Sec. 404(a)(3)(A)(i)(II).
4. IRC Sec. 404(l); Notice 2012-67 (Dec. 10, 2012), IR-2013-86 (Oct. 31, 2013).
5. IRC Sec. 404(a)(12).
6. IRC Secs. 404(a)(3), 404(a)(7), 404(a)(9).

the employee shares in profits for the final year.[1] Compensation paid to seasonal and part-time employees who are not eligible to participate in the plan may not be included in calculating the 25 percent limit; neither can compensation paid to employees who terminate before any allocation is made and whose allocations made after termination would be immediately forfeitable.[2]

Where contributions are made to the trusts of two or more profit sharing or stock bonus plans, the trusts are considered a single trust for purposes of the 25 percent limit.[3] The limit is applied by aggregating all contributions to such plans and limiting the total to 25 percent of the aggregate compensation of the employees covered by the plans.[4]

Amounts in excess of the 25 percent limit contributed in any year (called a contribution carry-over) may be deducted in succeeding years. Nondeductible contributions are generally subject to a 10 percent excise tax (Q 3840). For any succeeding year, the deduction for current contributions and contribution carry-overs cannot exceed 25 percent of participating payroll for the taxable year.[5] Excess contributions made in a year when the trust is exempt may be carried over and deducted in a succeeding year even though the trust is no longer exempt in the succeeding year.[6]

The amount of contributions taken into account by profit sharing or stock bonus plans must be reduced by any annual additions in excess of the Section 415 limits.[7] The excess amount may not be carried over and deducted in a later year.[8]

Contributions do not need to be made from current or accumulated profits to be deductible.[9]

Restorative payments. Amounts paid to a defined contribution plan as restoration for plan losses that result from a fiduciary breach (or a reasonable risk of liability for a fiduciary breach), are not contributions for purposes of the deduction limit.[10] The same reasoning was applied in a 1998 private ruling where an employer made a restorative contribution to replace plan losses in derivatives to avoid litigation with plan participants.[11] In contrast, payments that are made to a plan to make up for losses due to market fluctuations, but not due to a fiduciary breach, will be treated as contributions subject to the limit, not as restorative payments.[12] The IRS treated payments back to a plan to offset annuity surrender charges as contributions in one ruling,[13] but as restorative payments in another.[14]

1. See Rev. Rul. 65-295, 1965-2 CB 148.
2. See *Dallas Dental Labs v. Comm.*, 72 TC 117 (1979).
3. IRC Sec. 404(a)(3)(A)(iv).
4. Let. Rul. 9635045.
5. Treas. Reg. §1.404(a)-9(e).
6. Treas. Reg. §1.404(a)-9(a).
7. IRC Sec. 404(j)(1).
8. Notice 83-10, 1983-1 CB 536, F-1.
9. See IRC Sec. 401(a)(27).
10. Rev. Rul. 2002-45, 2002-2 CB 116. See Let. Ruls. 9506048, 9628031.
11. See Let. Rul. 9807028.
12. Rev. Rul. 2002-45, 2002-2 CB 116.
13. Let. Rul. 200317048.
14. Let. Rul. 200337017.

3696. What special qualification requirements apply to profit sharing plans but not to pension plans?

A profit sharing plan is a defined contribution plan that allows for discretionary employer contributions (as opposed to a money purchase pension plan with a fixed contribution as a percentage of participant compensation). Because employer contributions are discretionary, they can be a means for sharing employer profits with employees and their beneficiaries. All 401(k) plans must be profit sharing plans. A profit sharing plan must provide (1) a definite predetermined formula for allocating contributions and trust earnings among the participants, (2) for periodic valuation of trust assets, and (3) for distribution of the funds accumulated under the plan after a fixed number of years (meaning at least two years), on the attainment of a stated age, or on the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment (Q 3694).[1]

Profit sharing plans (as opposed to money purchase pension plans) have few restrictions on distributions. The IRS has ruled that a plan could permit participants with at least five years of participation to withdraw all employer contributions (including those made during the last two years).[2] With respect to amounts rolled over from another qualified plan, the receiving profit sharing plan must comply with the "fixed number of years" requirement without reference to the number of years such amounts accumulated in the previous plan.[3] Where a participant's entire account balance transfers to another qualified plan, the years of participation in both plans may be aggregated.[4]

It is not necessary that the employer contributes every year, contributes the same amount every year, or contributes in accordance with the same ratio every year. Merely making a single or occasional contribution for employees, however, does not establish a profit-sharing plan. To be a profit-sharing plan, there must be recurring and substantial contributions.[5]

A provision for offsetting contributions under a profit sharing plan by contributions made to a money purchase pension plan will not prevent either plan from qualifying.[6]

In a profit sharing plan, an age lower than sixty-five may be specified as retirement age.[7]

Withdrawal of Contributions

If a plan provides that employer contributions are allocated on the basis of employee contributions that may be withdrawn immediately after they are made, the plan will not qualify because such a withdrawal provision "could reasonably be expected to result in the manipulation of the

1. Treas. Reg. §1.401-1(b)(1)(ii); Rev. Rul. 71-295, 1971-2 CB 184; Rev. Rul. 80-155, 1980-1 CB 84.
2. Rev. Rul. 68-24, 1968-1 CB 150.
3. Let. Rul. 8134110.
4. Let. Rul. 8825130.
5. Treas. Reg. §1.401-1(b)(2).
6. Rev. Rul. 81-201, 1981-2 CB 88.
7. Rev. Rul. 80-276, 1980-2 CB 131.

allocation and contravention of the definite predetermined allocation formula requirement of Section 1.401-1(b)(1)(ii) of the regulations."[1]

If, on the other hand, the withdrawal provision imposes a "substantial limitation" on the right of a participant to withdraw his or her own contributions, so that the provision "cannot reasonably be expected to result in the manipulation of the allocation" as described above, this provision will not cause a plan to fail to qualify.[2]

Valuation of Assets

If amounts allocated or distributed to a particular participant are to be ascertainable, the plan must provide for a valuation of investments held by the trust at least once a year, on a specified inventory date, in accordance with a method consistently followed and uniformly applied. The fair market value on the inventory date is to be used for this purpose. The respective accounts of the participants are adjusted in accordance with the valuation.[3]

If a fully insured profit sharing plan provides that all trust assets are to be invested immediately in individual annuity or retirement income contracts, the cash value of which at any particular time is contained in a schedule supplied by the insurance company, the plan need not provide for the periodic valuation of trust investments.[4]

401(k) Plans

3697. What is a 401(k) plan?

A 401(k) plan generally is a profit sharing plan or stock bonus plan that provides for contributions to be made pursuant to a "cash or deferred arrangement" ("CODA") under which individual participants elect to take either amounts in cash or to have the amounts deferred under the plan. With the availability of Roth contributions under 401(k) plans, the employee also may elect to have Roth deferrals made on an after-tax basis to the CODA.

In addition to the general qualification requirements (Q 3758 through Q 3833), special qualification rules apply to 401(k) plans (Q 3698 to Q 3733). Certain nondiscrimination requirements can be met by satisfying the requirements for safe harbor plans (Q 3710). There are requirements for SIMPLE 401(k) plans (Q 3715) and there are automatic enrollment plans for plan years beginning after 2007 (Q 3707).

The elective deferral limits apply to individuals participating in more than one salary reduction plan, such as a 401(k) plan and a Section 403(b) tax sheltered annuity or SIMPLE IRA (Q 3705). There also are requirements that pertain to catch-up contributions by participants age fifty or over (Q 3706).

1. Rev. Rul. 72-275, 1972-1 CB 109, *as modified by* Rev. Rul. 74-55, 1974-1 CB 89.
2. Rev. Rul. 74-56, 1974-1 CB 90. *See also* Let. Rul. 7816022.
3. Rev. Rul. 80-155, 1980-1 CB 84.
4. Rev. Rul. 73-435, 1973-2 CB 126.

Amounts deferred under a 401(k) plan are referred to as elective deferrals (Q 3705). Elective deferrals generally are excluded from a participant's gross income for the year of the deferral and are treated as employer contributions to the plan.[1] In the case of contributions to a qualified Roth contribution program (Q 3716), deferrals are made on an after-tax basis (i.e., they are treated as includable in income for withholding purposes).[2]

A 401(k) plan may provide that all employer contributions are made pursuant to the election or may provide that the cash or deferred arrangement is in addition to ordinary employer contributions. Typically, the employer contributions are in the form of a percentage match for each dollar deferred by an employee. There are requirements that apply to matching contributions (Q 3732, Q 3733).

3698. What special qualification requirements apply to 401(k) plans?

To qualify, a 401(k) plan (or a plan that provides a 401(k) cash or deferred arrangement) generally must first be a qualified profit sharing or stock bonus plan.[3]

Contributions to the plan made under a cash or deferred arrangement must satisfy the nondiscrimination in amount requirement (Q 3731), be subject to withdrawal restrictions (Q 3731), and will not be included in the employee's gross income unless the employee elects to treat the contributions as designated Roth contributions (Q 3716).

3699. What types of employers are eligible to offer 401(k) plans?

Tax-exempt employers such as 501(c)(3) organizations are eligible to offer 401(k) arrangements.[4] State and local government employers (including political subdivisions and agencies thereof) generally are prohibited from offering 401(k) arrangements to their employees, but certain rural cooperatives may do so.[5]

3700. What is a cash or deferred arrangement ("CODA") in the context of a 401(k) plan?

A "cash or deferred arrangement" ("CODA") is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions, accruals, or other benefits in a qualified plan.[6] A cash or deferred election is any direct or indirect election (or modification of an earlier election) by an employee to have the employer either (1) provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available, or (2) contribute an amount to a trust, or provide an accrual or other benefit under a plan deferring the receipt of compensation.[7]

1. Treas. Regs. §1.401(k)-1(a).
2. See IRC Sec. 402A.
3. IRC Sec. 401(k); Treas. Reg. §1.401(k)-1(a)(1).
4. IRC Sec. 401(k)(4)(B)(i).
5. See IRC Secs. 401(k)(1), 401(k)(2), 401(k)(4)(B)(ii).
6. See Treas. Reg. §1.401(k)-1(a)(2).
7. Treas. Reg. §1.401(k)-1(a)(3).

With respect to timing, the final regulations provide that "a contribution is made pursuant to a cash or deferred election only if the contribution is made after the election is made."[1] See Q 3836 with regard to deduction timing. Under final regulations, amounts contributed in anticipation of future performance of services generally are not treated as elective contributions. A very limited exception is provided for administrative convenience (e.g., a company bookkeeper is absent the day the funds normally would be transmitted to the plan).[2] Special penalties and reporting requirements apply to listed transactions (Q 3975).[3]

Automatic enrollment. For purposes of determining whether an election is a cash or deferred election, it is irrelevant whether the default that applies in the absence of an affirmative election is that the employee receives cash or that the employee contributes the specified amount to the trust.[4] In plan years beginning after 2007, a safe harbor is available for plans that provide for automatic enrollment and satisfy certain additional requirements (Q 3707).

A cash or deferred arrangement does not qualify as such if any other benefit provided by the employer, except for matching contributions, is conditioned on the employee's making an election under the plan. "Other benefits" is illustrated in the regulations.[5] The IRS has privately ruled that the purchase of a group long-term disability income policy that provided continuation of benefit accumulation for disabled employees did not violate this rule.[6]

The IRS repeatedly has approved plans involving a "wraparound" arrangement, whereby contributions consisting of current year salary deferrals were held initially in a nonqualified deferred compensation plan (Q 3559). The IRS concluded that such deferrals were not impermissibly conditioned on the deferral election.[7] Final regulations state that a plan will not fail to be qualified merely because it includes a nonqualified cash or deferred arrangement, but special requirements will apply to its nondiscrimination testing.[8]

Elective deferral contributions to a 401(k) cash or deferred arrangement, including Roth contributions (Q 3716), are treated as employer contributions except when they are recharacterized (Q 3733).[9] Contributions need not come from employer profits.[10]

3701. What elective deferral limits are applicable to 401(k) plans?

The plan must provide that the amount any employee can elect to defer for any calendar year under the cash or deferred arrangement of any plan is limited to $17,500 (in 2013 and 2014, up from $17,000 in 2012), and is subject to indexing for inflation thereafter (Q 3705).[11] Plans also may allow additional elective deferrals, known as catch-up contributions, by participants age

1. Treas. Regs. §§1.401(k)-1(a)(3)(iii)(B).
2. See Treas. Regs. §§1.401(k)-1(a)(3)(iii)(C)(2).
3. See IRC Sec. 6707A.
4. See Treas. Reg. §1.401(k)-1(a)(3)(ii).
5. IRC Sec. 401(k)(4)(A); Treas. Reg. §1.401(k)-1(e)(6); see Let. Rul. 9250013.
6. Let. Ruls. 200235043, 200031060.
7. See e.g., Let. Ruls. 199924067, 9807010, 9752017, 9530038.
8. See Treas. Reg. §1.401(k)-1(a)(5)(iv).
9. Treas. Reg. §1.401(k)-1(a)(4)(ii).
10. IRC Sec. 401(a)(27).
11. IRC Secs. 401(a)(30), 402(g)(1); Notice 2011-90 (Nov 21, 2011); Notice 2012-67 (Dec. 10, 2012), IR-2013-86 (Oct. 31, 2013).

fifty or over. These catch-up contributions, if made under the provisions of IRC Section 414(v), are not subject to the Section 401(a)(30) limit (Q 3706).[1]

3702. What participation and coverage requirements apply to 401(k) plans?

A plan may not require, as a condition of participation in the cash or deferred arrangement, that an employee complete a period of service beyond the later of age twenty-one or the completion of one year of service.[2]

A cash or deferred arrangement must satisfy a nondiscriminatory coverage test (Q 3762).[3] For purposes of applying those tests, all eligible employees are treated as benefiting under the arrangement, regardless of whether they actually make elective deferrals.[4] An eligible employee is any employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. An employee is not ineligible merely because he or she elects not to participate, is suspended from making an election under the hardship withdrawal rules, is unable to make an election because his or her compensation is less than a specified dollar amount, or because he or she may receive no additional annual additions under the IRC Section 415 limits (Q 3677, Q 3784).[5]

Employers may apply an early participation test for certain younger or newer employees permitted to participate in a plan. If a plan separately satisfies the minimum coverage rules of IRC Section 410(b), taking into account only those employees who have not completed one year of service or are under age twenty-one, an employer may elect to exclude any eligible nonhighly compensated employees who have not satisfied the age and service requirements for purposes of the ADP test (Q 3731).[6] This provision is designed to encourage employers to allow newer and younger employees to participate in a plan without having the plan's ADP results "pulled down" by their often-lower rates of deferral. By making this election, an employer will be able to apply a single ADP test comparing the highly compensated employees who are eligible to participate in the plan to the nonhighly compensated who have completed one year of service and reached age twenty-one.

If an employer includes a tax-exempt 501(c)(3) organization and sponsors both a 401(k) (or 401(m)) plan and a Section 403(b) plan, employees eligible to participate in the Section 403(b) plan generally can be treated as excludable employees for purposes of the 401(k) plan if (1) no employee of the 501(c)(3) organization is eligible to participate in the 401(k) (or 401(m)) plan and (2) at least 95 percent of the employees who are not 501(c)(3) employees are eligible to participate in the 401(k) or 401(m) plan.[7]

Guidelines and transition rules for satisfying the coverage requirement during a merger or acquisition are set forth at Revenue Ruling 2004-11.[8]

1. IRC Sec. 414(v)(3)(A).
2. IRC Sec. 401(k)(2)(D).
3. IRC Sec. 401(k)(3)(A)(i).
4. Treas. Reg. §1.410(b)-3(a)(2)(i).
5. Treas. Reg. §1.401(k)-6.
6. IRC Sec. 401(k)(3)(F); Treas. Reg. §1.401(k)-2(a)(1)(iii).
7. Treas. Reg. §1.410(b)-6(g).
8. 2004-7 IRB 480.

3703. What rules regarding nonforfeitability of benefits apply to 401(k) plans?

An employee must be fully vested at all times in his or her elective contributions and cannot be subject to the forfeitures and suspensions that are permitted by the IRC for benefits derived from employer contributions (Q 3785). Furthermore, such amounts cannot be taken into consideration in applying the vesting rules to other contributions.[1]

Employer matching contributions and nonelective employer contributions that are taken into account for purposes of satisfying the special nondiscrimination rules applicable to cash or deferred arrangements (Q 3731) must be immediately nonforfeitable and subject to the withdrawal restrictions explained in Q 3729.[2] All other contributions to a plan that includes a cash or deferred arrangement also are subject to these restrictions unless a separate accounting is maintained.[3] Contributions made under a SIMPLE 401(k) plan are subject to special nonforfeitability requirements (Q 3715).

3704. What aggregation requirements apply to 401(k) plans?

Cash or deferred arrangements included in a plan generally are treated as a single cash or deferred arrangement for purposes of meeting the requirements discussed in Q 3699 through Q 3703, and for purposes of the coverage requirements of IRC Section 410(b).[4] The deferral percentage taken into account under the ADP tests for any highly compensated employee who is a participant in two or more cash or deferred arrangements under plans of the participant's employer that are required to be aggregated (as discussed above) is the average of the deferral percentages for the employee under each of the arrangements.[5]

Restructuring may not be used to demonstrate compliance with the requirements of IRC Section 401(k).[6]

3705. What is the limit on elective deferrals to employer-sponsored plans?

The IRC limits the total amount of "elective deferrals" any individual can exclude from income in a year. Elective deferrals, for this purpose, generally include all salary deferral contributions to all 401(k) plans (Q 3697 through Q 3716), tax sheltered annuities (Q 3921), SAR-SEPs (Q 3653), and SIMPLE IRAs (Q 3654).[7] Contributions under a Roth 401(k) feature (Q 3716) are subject to the same elective deferral limit as other 401(k) contributions.[8]

The elective deferral limit for traditional and safe harbor 401(k) plans and for Section 403(b) tax sheltered annuities is $17,500, as indexed (in 2013 and 2014, up from $17,000 in 2012).[9]

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1. IRC Sec. 401(k)(2)(C); Treas. Reg. §1.401(k)-1(c); *see also* Treas. Reg. §1.401(k)-1(c).
2. See Treas. Regs. §1.401(k)-1(c), 1.401(k)-1(d).
3. Treas. Reg. §1.401(k)-1(e)(3).
4. See Treas. Reg. §1.401(k)-1(b)(4)(ii).
5. IRC Sec. 401(k)(3)(B).
6. Treas. Reg. §1.401(k)-1(b)(4)(iv)(B).
7. IRC Sec. 402(g)(3); Treas. Reg. §1.402(g)-1(b).
8. See IRC Sec. 402A (a)(1). Similar rules have recently been adopted with respect to the federal Thrift Savings Plan. 77 Fed. Reg. 26417 (May 4, 2012).
9. IRC Sec. 402(g)(1); Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).

Elective deferral contributions to SIMPLE IRAs (Q 3654) and SIMPLE 401(k) plans (Q 3715) are subject to a limit of $12,000 in 2013 and 2014 (up from $11,500 in 2012).[1] The limit on elective deferrals to tax sheltered annuity plans may be further increased in the case of certain long term employees of certain organizations (Q 3921).[2]

The IRC Section 402(g) elective deferral limit is not required to be coordinated with the limit on Section 457 plans. As a result, an individual participating in both a 401(k) plan and a Section 457 plan in 2013 may defer as much as $35,000 (Q 3568).[3]

Matching contributions made on behalf of self-employed individuals generally are not treated as elective deferrals for purposes of IRC Section 402(g). This treatment does not apply to qualified matching contributions that are treated as elective contributions for purposes of the ADP test (Q 3731).[4]

Excess deferrals. Amounts deferred in excess of the ceiling (i.e., excess deferrals) are not excludable and, therefore, must be included in the individual's gross income for the taxable year.[5] In the case of participants age fifty or over, catch-up contributions permitted under IRC Section 414(v) are not treated as excess elective deferrals under IRC Section 402(g)(1)(C) (Q 3706).[6]

If any amount is included in an individual's income under these rules and plan language permits distributions of excess deferrals, the individual, prior to the first April 15 following the close of the individual's taxable year, may allocate the excess deferrals among the plans under which the deferrals were made and the plans may distribute the excess deferrals (including any income allocated thereto, provided the plan uses a reasonable method of allocating income) not later than the first April 15 of the close of the plan's taxable year.[7] The amount of excess deferrals distributed under these rules is not included in income a second time as a distribution, but any income on the excess deferral is treated as earned and received, and includable in income in the taxable year in which distributed.[8] If the plan so provides, distributions of excess deferrals may be made during the taxable year of the deferral if the individual and the plan designate the distribution as an excess deferral and the correcting distribution is made after the date on which the plan received the excess deferral.[9]

Excess amounts that are not timely distributed are not included in the cost basis of plan distributions, even though they have previously been included in income.[10] Thus, such amounts will be subjected to a second tax when distributed in the future. Any corrective distribution of

1. Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
2. Treas. Reg. §1.402(g)-1(c).
3. See IRC Sec. 457(c).
4. See IRC Sec. 402(g)(8).
5. IRC Sec. 402(g)(1); Treas. Reg. §1.402(g)-1(a).
6. Treas. Reg. §1.414(v)-1(g).
7. Treas. Regs. §§1.402(g)-1(e)(2), 1.402(g)-1(e)(5).
8. IRC Sec. 402(g)(2)(C); Treas. Reg. §1.402(g)-1(e)(8).
9. Treas. Reg. §1.402(g)-1(e)(3).
10. IRC Sec. 402(g)(2); Treas. Reg. §1.402(g)-1(e)(8).

less than the entire amount of the excess deferral is treated as a pro rata distribution of excess deferrals and income.[1]

Planning Point: Due to the potential for double taxation, excess elective deferrals should be avoided, and, if they inadvertently occur, should be corrected by the applicable deadline. One common trap for the unwary may occur where an individual participates in more than one plan that allows elective deferrals. Perhaps he or she participates in a 401(k) plan at his or her regular place of employment, and also participates in a SIMPLE IRA plan sponsored by a side business. The limits on elective deferrals are applied to the individual and not just to the plan, so the individual easily might stay within the terms of the two plans and still violate the elective deferral limits by contributing the maximum amount to both plans. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

For rules on coordinating distributions of excess contributions (Q 3733) and excess deferrals.[2]

3706. What are the rules for catch-up contributions to employer sponsored retirement plans?

Catch-up contributions are defined as additional elective deferrals by an eligible participant in an applicable employer plan, as defined in IRC Section 414(v) and regulations thereunder. Elective deferral for this purpose refers to the amounts described in IRC Section 402(g)(3) (Q 3705), but also includes amounts deferred to eligible Section 457 governmental plans.[3] The provisions allowing catch-up contributions are among the retirement amendments of EGTRRA 2001 that became permanent under the Pension Protection Act of 2006 ("PPA 2006").[4]

For purposes of IRC Section 414(v), an applicable employer plan means:

(1) employer plans qualified under IRC Section 401(a) (Q 3758),

(2) Section 403(b) tax sheltered annuities (Q 3921),

(3) eligible Section 457 governmental plans,

(4) salary reduction simplified employee pensions (i.e., SAR-SEPs (Q 3653), and

(5) SIMPLE IRAs (Q 3654).[5]

For this purpose, qualified plans, Section 403(b) plans, SAR-SEPs, and SIMPLE IRAs that are maintained by a controlled group of corporations, a group of trades or businesses under common control, or members of an affiliated service group (Q 3832) are considered one plan. In addition, if more than one eligible Section 457 governmental plan is maintained by the same employer, the plans will be treated as one plan.[6]

1. IRC Sec. 402(g)(2)(D); Treas. Reg. §1.402(g)-1(e)(10).
2. See Treas. Reg. §1.401(k)-1(f)(5)(i).
3. IRC Secs. 414(v)(5)(B), 414(u)(2)(C) (USERRA rights); Treas. Reg. §1.414(v)-1(g)(2).
4. See P.L. 109-280, Sec. 811.
5. IRC Sec. 414(v)(6).
6. IRC Sec. 414(v)(2)(D).

Catch-up contributions permitted under IRC Section 414(v) do not apply to a catch-up eligible participant for any taxable year in which a higher catch-up amount is permitted under IRC Section 457(b)(3) during the last three years prior to the plan's normal retirement year (Q 3568).[1]

Dollar limit. A plan may not permit additional elective deferrals for any year in an amount greater than the lesser of (1) the indexed amount listed below or (2) the excess (if any) of the participant's compensation as defined in IRC Section 415(c)(3) (Q 3784, Q 3677) over any other elective deferrals for the year made without regard to the catch-up limits.[2] An employer that sponsors more than one plan must aggregate the elective deferrals treated as catch-up contributions for purposes of the dollar limit.[3] An individual participating in more than one plan is subject to one annual dollar limit for all catch-up contributions during the taxable year.[4]

The indexed dollar limit on catch-up contributions to SIMPLE IRAs and SIMPLE 401(k) plans is $2,500 for the 2011 through 2014 plan years.[5] The indexed dollar limit on catch-up contributions to all other 401(k) plans and to Section 403(b) plans, eligible Section 457 plans, and SAR-SEPs is $5,500 for 2011 through 2014 plan years.[6]

Eligible participant. An eligible participant with respect to any plan year is a plan participant who would attain age fifty before the end of the taxable year and with respect to whom no other elective deferrals may be made to the plan for the plan (or other applicable) year as a result of any limit or other restriction.[7] For this purpose, every participant who will reach age fifty during a plan year is treated as having reached age fifty on the first day of the plan year, regardless of the employer's choice of plan year and regardless of whether the participant survives to age fifty or terminates employment prior to his or her birthday.[8]

Universal availability. A plan will not satisfy the nondiscrimination requirements of IRC Section 401(a)(4) unless all catch-up eligible participants who participate in any applicable plan maintained by the employer are provided with the effective opportunity to make the same election with respect to the dollar limits described above.[9] This is known as the universal availability requirement. A plan will not fail to satisfy this requirement merely because it allows participants to defer an amount equal to a specified percentage of compensation for each payroll period and permits each catch-up eligible participant to defer a pro rata share of the dollar catch-up limit in addition to that amount.[10]

1. IRC Sec. 414(v)(6)(C); Treas. Reg. §1.414(v)-1(a)(3).
2. IRC Sec. 414(v)(2)(A).
3. Treas. Reg. §1.414(v)-1(f)(1).
4. Treas. Regs. §§1.402(g)-2(b), 1.414(v)-1(f)(3).
5. Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
6. Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
7. IRC Sec. 414(v)(5).
8. See Treas. Reg. §1.414(v)-1(g)(3).
9. IRC Sec. 414(v)(4)(A); Treas. Reg. §1.414(v)-1(e).
10. Treas. Reg. §1.414(v)-1(e).

For purposes of the universal availability requirement, all plans maintained by employers that are treated as a single employer under the controlled group, common control, or affiliated service group rules (Q 3830, Q 3832) generally must be aggregated.[1] Exceptions to the aggregation rule apply to Section 457 plans and certain newly acquired plans.[2]

Catch-up contributions are excluded from income in the same manner as elective deferrals.[3] The calculation of the elective deferrals that will be considered catch-up contributions generally is made as of the end of the plan year by comparing the total elective deferrals for the plan year with the applicable plan year limit.[4] Elective deferrals in excess of the plan, ADP, or IRC limits, but not in excess of the amount limitations described above, will be treated as catch-up contributions as determined on the last day of the plan year.[5]

An employer may make, but is not required to make, matching contributions on catch-up contributions. If an employer does so, the contributions must satisfy the ACP test of IRC Section 402(m) (Q 3732).[6] Reporting requirements for catch-up contributions are set forth in Announcement 2001-93.[7]

3707. What is a solo 401(k) plan?

A solo 401(k) plan refers to any 401(k) plan that covers only one participant. Solo 401(k) plans are a product of qualified plan reforms implemented by EGTRRA 2001, which substantially improved the tax favored treatment for employers sponsoring 401(k) plans. These changes were designed to encourage greater savings for retirement and to provide more incentive to businesses funding 401(k) plans.

The first of these changes increased the deduction limit for profit sharing and stock bonus plans (which includes 401(k) plans) to 25 percent of compensation.[8] Before 2002, profit sharing and stock bonus plans were subject to a deduction limit of 15 percent of compensation.

Planning Point: For self-employed individuals, compensation is defined as net earnings less deduction of 50 percent of self-employment tax and employee contributions. The IRS publishes a separate deduction and rate worksheet for self-employed individuals in Pub. 560.

Second, the definition of compensation for purposes of the 25 percent limit includes elective deferrals to a qualified plan, Section 403(b) plan, Section 457 plan, SEP, SIMPLE, or Section 125 FSA plan.[9] This means that the payroll on which the 25 percent is based became higher than it was in earlier years, resulting in a higher deduction limit for employer contributions to the plan.

1. IRC Sec. 414(v)(4)(B).
2. See Treas. Reg. §1.414(v)-1(e)(2) and (3).
3. See IRC Sec. 402(g)(1)(C).
4. Treas. Reg. §1.414(v)-1(b)(2).
5. Treas. Reg. §1.414(v)-1(c).
6. See T.D. 9072, 2003-2 C.B. 527.
7. 2001-44 IRB 416.
8. See IRC Section 404(a)(3)(A).
9. See IRC Sec. 404(a)(12).

Planning Point: If a self-employed individual also participates as an employee in another 401(k) plan, the limits on elective contributions are per individual, not per plan.

After the EGTRRA 2001 amendments, elective deferrals no longer reduced the amount of employer contributions for purposes of calculating the 25 percent deduction limit.[1] This meant that a higher amount could be attributable to matching contributions, nonelective contributions or other amounts paid by the employer. The elective deferral limits increased as well: the limit is $17,500 in 2013 and 2014, $17,000 in 2012 (up from $16,500 in 2011) (Q 3705), and, for individuals age fifty or older, catch-up contributions are permitted ($5,500 in 2011-2014) (Q 3706).[2]

Planning Point: These changes to the calculation of the employer deduction for all profit sharing plans, including 401(k) plans, led to a proliferation of solo 401(k) plans. Although the advantages to a sole proprietor or one person corporation can be significant, it is important to note that the plan is subject to the same minimum participation, coverage, nondiscrimination, and other requirements that apply to any other qualified defined contribution plan, in the event one or more employees are later added to the sponsoring employer.

Third, total contributions to an employee's account (excluding catchup contributions) cannot exceed $52,000 in 2014, (up from $51,000 in 2013).[3]

3708. What is an automatic enrollment safe harbor 401(k) plan?

The Pension Protection Act of 2006 created a new safe harbor plan under Section 401(k) called a "qualified automatic contribution arrangement," available for plan years beginning after 2007.[4]

Plans that provide for automatic enrollment and meet certain other requirements for the safe harbor will satisfy the ADP/ACP requirements (Q 3698, Q 3731) and be excluded from the top heavy requirements (Q 3817 to Q 3823). For this treatment to apply, a plan must satisfy an automatic deferral requirement, an employer contribution requirement, and a notice requirement.[5]

The automatic deferral requirement states that each employee eligible to participate in the plan must be treated as having elected to have the employer make elective contributions equal to a "qualified percentage." The threshold amount of the automatic deferral percentage may not be less than 3 percent for the first year the deemed election applies. Employees may affirmatively elect out of the plan or elect a different deferral percentage. In the second year, this default percentage must increase to 4 percent, then 5 percent in the third year, and 6 percent in the fourth year and thereafter.[6] A plan may provide for a higher percentage so long as it is applied uniformly, although the percentage may not exceed 10 percent. The contributions generally must

1. See IRC Sec. 404(n).
2. See IRC Secs. 402(g)(1), 414(v)(2)(B); IR-2010-108 (Oct. 28, 2010); Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
3. Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
4. See IRC Sec. 401(k)(13); P.L. 109-280, Sec. 902(g).
5. See IRC Sec. 401(k)(13)(B).
6. IRC Sec 401(k)(13)(C).

continue until the last day of the plan year that begins after the date on which the first elective contribution under the automatic deferral requirement is made with respect to the employee.[1]

An employer also must provide either a matching or a nonelective contribution. The match amount must be 100 percent of the first 1 percent of compensation deferred, plus 50 percent of the amount of elective contributions over 1 percent but not exceeding 6 percent of compensation deferred. If an employer provides a nonelective contribution, it must be an amount equal to 3 percent of compensation for each employee eligible to participate in the arrangement.[2] The plan may impose a two year vesting requirement with respect to employer contributions, but employees then must be 100 percent vested after two years.[3]

The written notice requirement is met if within a reasonable period before each plan year, each employee who is eligible to participate in the plan receives a written notice of his or her rights and obligations under the plan. The notice must be sufficiently accurate and comprehensive to apprise the employee of those rights and obligations, and it must be written in a manner that is calculated to be understood by the average employee to whom the plan applies. The notice must explain the employee's right to elect not to have elective contributions made under the plan, or to have contributions made at a different percentage. If the plan allows the employee to choose from among two or more investment options, the notice must inform the employee how the account will be invested in the absence of any investment election. The employee also must have a reasonable period of time after receipt of the notice and before the first elective contribution to make one of the foregoing elections.[4]

Relief Provisions

Effective August 17, 2006, ERISA preempts any state laws that would "directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement."[5] This provision is designed to resolve the problem of state laws that treat automatic withholding by a 401(k) arrangement as a prohibited garnishment of wages. The DOL is authorized to issue regulations establishing minimum standards that an arrangement would have to satisfy to qualify for the application of this provision.[6]

For plan years beginning after 2007, relief from the 401(k) distribution restrictions (Q 3729) and the 10 percent penalty (Q 3860) is available during the first ninety days following the start of automatic deferrals, in the event that contributions are withheld erroneously. This relief applies not only to automatic enrollment safe harbor plans, but to other automatic enrollment plans that meet the definition of an "eligible automatic contribution arrangement."[7]

1. See IRC Sec. 401(k)(13)(C)(iii).
2. See IRC Sec. 401(k)(13)(D)(i).
3. See IRC Sec. 401(k)(13)(D)(iii)(I).
4. See IRC Sec. 401(k)(13)(E).
5. See ERISA Sec. 514(e).
6. PPA 2006, Sec. 902(f)(1).
7. See IRC Sec. 414(w)(1).

An eligible automatic contribution arrangement is a plan:

(1) under which a participant may elect to have the employer make payment as contributions under the plan on behalf of the participant, or to the participant directly in cash,

(2) under which the participant is treated as having elected to have the employer make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made or elects a different percentage;

(3) under which, in the absence of an investment election by the participant, the contributions are invested under the provisions of new ERISA Section 404(c)(5), in accordance with regulations described below; and

(4) that meets certain notice requirements.[1]

The timing and content of the notice requirement is virtually identical to that of the automatic enrollment safe harbor, set forth above.[2]

Refunds of excess contributions and excess aggregate contributions (Q 3733) from eligible automatic contribution arrangements will be subject to an extended time deadline. Instead of 2½ months, the plans will have six months to make refunds of such distributions.[3]

3709. When are default investments permitted under a 401(k) plan?

For plan years beginning after 2006, participants in individual account plans that meet specific notice requirements will be deemed to have exercised control over the assets in their accounts with respect to the amount of contributions and earnings that, in the absence of an investment election by the participants, are invested by the plan in accordance with regulations.[4] Final regulations offer fiduciaries relief from liability for losses resulting from automatically investing participant accounts in a qualified default investment alternative. In addition, the fiduciary would not be liable for the decisions made by the entity managing the qualified default investment alternative. Fiduciaries, however, remain liable for prudently selecting and monitoring any qualified default investment alternative under the plan.[5]

For the regulatory relief to apply:

(1) the assets must be invested in a qualified default investment alternative, as defined below;

(2) the participant or beneficiary on whose behalf the account is maintained must have had the opportunity to direct the investment of the assets in his or her account but did not do so;

1. See IRC Sec. 414(w)(3).
2. See IRC Sec. 414(w)(4).
3. See IRC Sec. 4979(f).
4. ERISA Section 404(c)(5).
5. Labor Reg. §2550.404c-5(b).

(3) the participant or beneficiary must be provided with a notice meeting requirements set forth in regulations, a summary plan description, and a summary of material modification at least thirty days before the first investment and at least thirty days before each plan year begins;

(4) any material relating to the investment, such as account statements, prospectuses, and proxy voting material must be provided to the participant or beneficiary;

(5) the participant or beneficiary must be permitted to make transfers to other investment alternatives at least once in any three month period without financial penalty; and

(6) the plan must offer a "broad range of investment alternatives," as defined in DOL Regulation Section 2550.404c-1(b)(3).[1]

The notice required for a qualified default investment alternative must:

(1) describe the circumstances under which assets in the individual account of an individual or beneficiary may be invested on behalf of a participant or beneficiary in a qualified default investment alternative;

(2) explain the right of participants and beneficiaries to direct the investment of assets in their individual accounts;

(3) describe the qualified default investment alternative, including its investment objectives, risk and return characteristics (if applicable), and fees and expenses;

(4) describe the right of the participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative to direct the investment of those assets to any other investment alternative under the plan, without financial penalty, and

(5) explain where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.[2]

A qualified default investment alternative means an investment alternative that meets five requirements:

(1) it does not hold or permit the acquisition of employer securities except as provided below;

(2) it does not impose financial penalties or otherwise restrict the ability of the participant or beneficiary to make transfers from the default investment to another plan investment;

1. Labor Reg. §2550.404c-5(c).
2. Labor Reg. §2550.404c-5(d).

(3) it is managed by an investment manager, a registered investment company, or a plan sponsor that is a named fiduciary;

(4) it is diversified, to minimize the risk of large losses; and

(5) it constitutes one of three investment products (for example, a life cycle fund, a balanced fund, and a managed account) described in the regulations, each of which offers long-term appreciation and capital preservation through a mix of equity and fixed income exposures.[1]

Final regulations permit the use of capital preservation funds (money market or stable value funds) only for a limited duration of not more than 120 days after a participant's initial elective deferral. After 120 days, funds must be redirected to one of the three regular qualified default investment alternatives.[2]

The regulations set forth two exceptions for the holding of employer securities.

The first is for the acquisition of employer securities held or acquired by a registered investment company (or similar pooled investment vehicle that is subject to state or federal examination) with respect to which such investments are in accordance with the stated investment objectives of the investment vehicle and are independent of the plan sponsor or its affiliate.[3] In the preamble to the proposed regulations, the DOL explained that this exception should accommodate large publicly traded employers whose default investment alternatives may include pooled investment vehicles that invest in such companies.[4]

A second exception is provided with respect to accounts managed by an investment management service for employer securities acquired as a matching contribution from the employer/plan sponsor or for employer securities acquired prior to management by the investment management service.[5]

3710. What are the requirements for a 401(k) safe harbor plan?

The IRC requires that deferrals, matching, and after-tax employee contributions to 401(k) or 401(m) plans satisfy certain non-discrimination tests. A plan that is designed to meet certain safe harbors is deemed to have met those testing requirements. These tests are referred to as the ADP test for salary deferrals and the ACP test for employee after-tax and matching employer contributions. The requirements for meeting the safe harbors of 401(k) and 401(m) plans include specific plan provisions that generally require a fully vested employer contribution, one or more advance notice requirements, and certain restrictions on the level of discretionary matching contributions.

A plan may be designed to satisfy safe harbors for deferrals but not for the matching employer contribution.

1. Labor Reg. §2550.404c-5(e).
2. Labor Reg. §2550.404c-5(e).
3. Labor Reg. §2550.404c-5(e)(1)(ii)(A).
4. See 29 CFR Part 2550, 71 Fed. Reg. 56806 (Sept. 27, 2006).
5. Labor Reg. §2550.404c-5(e)(1)(ii)(B).

The safe harbor plan requirements prohibit placing restrictions on a participant's right to receive the match or 3 percent of pay employer contribution. Thus, the contribution must be given to employees who terminate employment in the plan year (Q 3731, Q 3732). The safe harbor does not eliminate the requirement of ACP testing for employee after-tax contributions.[1] In addition, 401(k) plans that meet the safe harbor of 401(k) and 401(m) generally are exempt from the top-heavy requirements (Q 3817 to Q 3823), except as explained below.[2]

Regulations permit the required safe harbor contributions to be made to the 401(k) plan or other defined contribution plans of the employer.[3] Except for the provisions described below, a safe harbor plan generally is subject to the same qualification requirements of IRC Section 401(a) as a traditional 401(k) plan.

The fact that a plan is a safe harbor 401(k) does not prevent certain lower income taxpayers from being eligible to claim the saver's credit for elective deferrals (Q 3607).

The dollar limit on elective deferrals to a safe harbor plan is the same as for a traditional 401(k) plan (Q 3705).

A safe harbor plan generally may also permit catch-up contributions by participants who reach age fifty (or more) by the end of the plan year.[4] The limit on catch-up contributions (Q 3706) to safe harbor plans is calculated in the same manner as if made to a non-safe harbor 401(k) plan.[5] The dollar limit for salary deferrals is $17,500 in 2013 and 2014 (up from $17,000 in 2012) and the catch-up contribution limit is $5,500 (in 2011-2014).[6]

Safe harbor 401(k) and 401(m) plans generally are exempt from the top-heavy requirements; where additional employer contributions are made (e.g., profit sharing), that exemption is lost.[7]

3711. What notice must be provided to participants in a 401(k) safe harbor plan?

Every year, an employer must provide certain written notices to each employee eligible to participate in a plan. This notice must be provided prior to the start of the plan year. The written notice must include a statement as to which type of safe harbor contribution will be made to the plan (i.e., the safe harbor match or safe harbor nonelective contribution). The statement must explain:

(1) how the contribution is calculated and whether any conditions exist to be eligible to use it, including a description of the levels of safe harbor matching contributions;

1. See IRC Secs. 401(k)(12), 401(m)(11); Treas. Reg. §1.401(k)-3(a).
2. IRC Sec. 416(g)(4)(H).
3. IRC Sec. 401(k)(12)(F); see Treas. Reg. §1.401(k)-3(h)(4).
4. See IRC Sec. 414(v).
5. IRC Sec. 414(v)(2)(A).
6. IRC Sec. 414(v)(2)(B)(i); Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
7. See IRC Sec. 416(g)(4)(H); Rev. Rul. 2004-13, 2004-7 IRB 485.

(2) whether any other contributions may be made under the plan or to another plan on account of elective contributions or after-tax employee contributions made to the plan;

(3) the plan to which safe harbor contributions will be made if it is different from the plan containing the cash or deferred arrangement;

(4) the type and amount of compensation that may be deferred under the plan;

(5) how to make cash or deferred elections, including any administrative requirements that apply to such elections;

(6) the periods available under the plan for making cash or deferred elections;

(7) withdrawal and vesting provisions applicable to contributions under the plan; and

(8) information that makes it easy to obtain additional information about the plan, including an additional copy of the summary plan description and telephone numbers, addresses, and, if applicable, electronic addresses, of individuals or offices from whom employees can obtain such plan information.[1]

A plan that fails to meet any of these requirements will fail to be a safe harbor plan and will require the ADP and/or ACP testing of the plan year.

The timing requirement for the notice requirement is satisfied if the notice is provided within a reasonable period before the beginning of the plan year. This requirement is deemed met if the notice is provided to each eligible employee at least thirty days, and not more than ninety days, prior to the end of the plan year (i.e., by December 1 for a calendar year).[2]

Contingent Notice

There is one type of 401(k) safe harbor plan that requires a contingent notice. This plan design allows the employer to wait until thirty days before the close of the plan year to decide if the plan will be a safe harbor plan by making the fully-vested 3 percent of compensation, nonelective safe harbor. This type of plan must provide a contingent notice before the start of the plan year and a second notice when the employer decides to make the safe harbor contribution. The contingent notice must set forth the same information as above, and also state that the plan may be amended during the plan year to include the 3 percent safe harbor contribution. If the employer elects to make the contribution, the plan must be amended to reflect the contribution. Both the amendment and the follow-up notice are required to be provided to each eligible employee at least thirty days prior to the end of the plan year (i.e., by December 1 for a calendar year plan).[3]

1. Treas. Reg. §1.401(k)-3(d)(2)(ii).
2. See Treas. Reg. §1.401(k)-3(d)(3).
3. See Treas. Reg. §1.401(k)-3(f).

Much of the information in the summary plan description can be cross referenced rather than set forth again in the notice.[1] In either case, the notice must be sufficiently accurate and comprehensive to inform the employee of his or her rights and obligations and must be written in a manner calculated to be understood by the average employee eligible to participate.[2]

3712. What requirements apply to matching contributions in the context of a 401(k) safe harbor plan?

The safe harbor matching contribution requirement is met if a matching contribution is made to each nonhighly compensated employee in one of two ways: the basic match or the enhanced match. Both become an obligation of the employer for the plan year (with certain exceptions).

The basic match is an employer contribution equal to 100 percent of the salary deferrals to the extent they do not exceed 3 percent of compensation, plus a match equal to 50 percent of the salary deferrals that exceed 3 percent but do not exceed 5 percent of the compensation.[3]

The enhanced match is a matching contribution equal to 100 percent of the employee's salary deferrals that do not exceed 4 percent of compensation.

The safe harbor match must be fully vested at all times. Matching of catch-up contributions is not required; if done, they must be provided for all participants.[4]

In no event may the rate of matching contributions for a highly compensated employee exceed that for a nonhighly compensated employee.[5] The IRC allows some variation on the basic formula described above, but the end result essentially must be the same as under these percentages and the rate of the match cannot go up with the rate of contributions.[6]

Matching contributions may be offered on both elective deferrals and employee after-tax contributions, provided that the match on elective deferrals is not affected by the amount of employee contributions, or matching contributions are made with respect to the sum of an employee's elective deferrals and employee contributions under the same terms as they are made with respect to elective deferrals.[7]

The IRS has stated that matching contributions may be made on the basis of compensation paid for a payroll period, a month, a quarter, or at year-end.[8] The selection of a pay period basis means that if the employer contributes more than is necessary to receive a match for the pay period, there is no requirement to increase the match in other periods when the employee defers less than enough to receive the maximum match. If an employee has restrictions placed

1. Treas. Reg. §1.401(k)-3(d)(2)(iii).
2. IRC Secs. 401(k)(12)(D), 401(m)(11)(A)(ii); see Treas. Reg. §1.401(k)-3(d)(2)(i).
3. IRC Secs. 401(k)(12)(B)(i), 401(m)(11)(A)(i).
4. See Reg-142499-01, 66 Fed. Reg. 53555 (Oct. 23, 2001).
5. IRC Secs. 401(k)(12)(B)(ii), 401(m)(11)(A)(i).
6. See IRC Secs. 401(k)(12)(B)(iii), 401(m)(11)(A)(i); see Treas. Reg. §1.401(k)-3(c)(3).
7. Treas. Reg. §1.401(k)-3(c)(5)(i).
8. Treas. Reg. §1.401(k)-3(c)(5)(ii).

on other deferrals (for example, takes an in-service hardship distribution), the plan will impose a six month suspension on participation to the same extent as required by a traditional 401(k) plan (Q 3730).[1]

A plan that satisfies the ADP test through safe harbor matching contributions automatically will satisfy the ACP test for certain discretionary contributions and the safe harbor match. The discretionary match cannot exceed 40 percent of compensation and cannot be based on deferrals exceeding 6 percent of compensation (Q 3732).

Likewise, a plan that satisfies the ADP test through the nonelective contribution safe harbor under Treasury Regulation Section 1.401(k)-3(b) automatically will satisfy the corresponding ACP test safe harbor as long as the same restrictions on matching contributions exist.[2] If the plan provides for additional matching contributions, then the ACP must be prepared.[3]

Nonelective Safe Harbor

The nonelective safe harbor contribution requirement is met if an employer contribution is made on behalf of all eligible nonhighly compensated employees in an amount equal to at least 3 percent of the employee's compensation.[4] This contribution is made to the accounts of all participants who are eligible, not just those making salary deferrals.

The nonelective contributions must be fully vested and subject to the withdrawal restrictions on IRC Section 401(k) plans (Q 3729).[5]

One important advantage of the 3 percent safe harbor contribution is that it may be used to satisfy the nondiscrimination requirements of IRC Section 401(c)(4). It is not subject to the limitations that apply to QNECs for use in such testing (Q 3731). Contributions used to satisfy the 3 percent safe harbor contribution may not be taken into account in determining whether a plan satisfies the permitted disparity rules (i.e., Social Security integration) (Q 3779).[6]

Discretionary Match to Safe Harbor Plan

Safe harbor plans retain their ability to satisfy the ACP test for discretionary matching contribution if the contributions are limited in amount. Those limits require that discretionary matching contributions may not be made where: (1) based on salary deferrals that are not in excess of 6 percent of the employee's compensation and limited to no more than 4 percent of the participant's compensation, (2) the rate of the employer's matching contribution does not increase with the rate of the employee's elective deferral or contribution, and (3) the matching contribution with respect to any highly compensated employee at any rate of employee

1. See Treas. Reg. §1.401(k)-3(c)(6)(v)(B).
2. Treas. Regs. §§1.401(m)-3(b), 1.401(m)-3(c).
3. See IRC Sec. 401(m)(11)(B).
4. IRC Secs. 401(k)(12)(C), 401(m)(11)(A)(i).
5. IRC Sec. 401(k)(12)(E)(i).
6. IRC Sec. 401(k)(12)(E)(ii); Treas. Reg. §1.401(k)-3(h)(2).

contribution or rate of elective deferral is not greater than that made with respect to a nonhighly compensated employee.[1]

If matching contributions are made in excess of this limitation, they will be required to prepare the ACP test for the plan year.[2]

3713. Can an employer reduce or suspend 401(k) safe harbor nonelective contributions mid-year?

The IRS has issued final regulations that permit a safe harbor nonelective 401(k) plan to reduce or suspend safe harbor contributions midyear if the plan contains a statement that such action is a possibility and the amendment does not become effective until 30 days after participants receive a supplemental notice of the midyear amendment.[3]

Previously, an employer was only permitted to exit a safe harbor nonelective 401(k) plan if the employer was experiencing a substantial business hardship. Factors to be considered in making this determination included whether the employer was operating at an economic loss, general industry conditions and whether the employer would be able to continue the plan without eliminating the safe harbor contributions.

As a result of the new regulations, an employer is able to design its plan to provide the option of reducing or eliminating safe harbor nonelective contributions regardless of profitability. The regulations are retroactively effective and apply to plan years beginning after May 18, 2009.[4]

3714. How does a SIMPLE 401(k) plan differ from a 401(k) safe harbor plan?

SIMPLE 401(k) plans (Q 3715) also provide a design-based alternative to the use of a safe harbor plan. Some of the differences between safe harbor plans and SIMPLE 401(k) plans are as follows:

(1) employees covered by a SIMPLE 401(k) plan may not be participants in any other plan offered by the employer, although employees participating in a safe harbor plan may be covered by more than one plan;

(2) SIMPLE 401(k) plans are subject to lower dollar limits on elective deferrals and catch-up contributions that apply to SIMPLE IRAs, not 401(k) traditional plans;

(3) employers offering a SIMPLE 401(k) plan may not offer any contributions other than those provided under the SIMPLE 401(k) requirements, although employers maintaining a safe harbor plan may do so within the limitations described in Q 3712;

1. IRC Sec. 401(m)(11)(B).
2. See 1996 Blue Book, p. 153.
3. Treas. Regs. §§1.401(k)–3(d), 1.401(k)–3(g), and 1.401(m)-3(h)
4. TD 9641.

(4) safe harbor plans may be offered by any employer, although SIMPLE 401(k) plans are available only to employers with 100 or fewer employees earning $5,000 or more in the preceding year; and

(5) contributions required under a safe harbor design may be made to a separate plan of the employer, although contributions required under a SIMPLE 401(k) design must be made to the SIMPLE 401(k) plan.

Planning Point: A SIMPLE 401(k) must file a Form 5500. With all this, one wonders why anyone would adopt a SIMPLE 401(k) plan when they could do the same funding in a SIMPLE IRA.

3715. What are the requirements for a SIMPLE 401(k) plan?

Of all the types of qualified plans that are permitted under the IRC, the SIMPLE 401(k) may be the least attractive to a plan sponsor. These plans retain all the eligibility, document, and reporting requirements of a qualified plan but are subject to the lower limits and other restrictions of a SIMPLE IRA. A SIMPLE 401(k) plan allows an eligible employer to satisfy the actual deferral percentage test for 401(k) plans (Q 3731) by meeting the plan design requirements described below, instead of performing annual ADP testing.[1] For a comparison of the features of a SIMPLE 401(k) plan to those of a safe harbor 401(k) plan, see Q 3715.

An eligible employer is one that had no more than 100 employees earning at least $5,000 of compensation from the employer for the preceding year.[2] An eligible employer that establishes a SIMPLE 401(k) plan for a plan year and later ceases to be eligible generally will be treated as eligible for the following two years. If the failure to remain eligible was due to an acquisition, disposition, or similar transaction, special rules apply.[3]

In addition to all the requirements of IRC Section 401(k), a SIMPLE 401(k) plan must meet the contribution and other requirements of SIMPLE IRAs. Those requirements include a contribution requirement, an exclusive plan requirement, and a vesting requirement (Q 3654, Q 3657).[4]

The SIMPLE 401(k) contribution requirement includes the following: (1) eligible employees must be able to make salary deferral contributions to the plan, (2) the amount to which the election applies may not exceed $12,000 (in 2013 and 2014, up from $11,500 in 2011 and 2012), and (3) the employer must make matching contributions or nonelective contributions under one of the formulas described below.[5]

A SIMPLE 401(k) plan also may permit catch-up salary deferral contributions by participants who have attained age fifty by the end of the plan year.[6] The limit on catch-up contributions to SIMPLE 401(k) plans is the same as for SIMPLE IRAs. The maximum catch-up contribution is

1. See IRC Sec. 401(k)(11); Treas. Reg. §1.401(k)-4(a).
2. IRC Secs. 401(k)(11)(D)(i), 408(p)(2)(C)(i).
3. See IRC Secs. 408(p)(10), 401(k)(11)(D)(i), 408(p)(2)(C)(i)(II); Treas. Reg. §1.401(k)-4(b)(2).
4. IRC Secs. 401(k)(11)(A), 401(k)(11)(D)(i).
5. IRC Sec. 401(k)(11)(B); Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
6. See IRC Sec. 414(v).

the lesser of $2,500 (for 2011-2014) or the excess (if any) of the participant's compensation over any other elective deferrals for the year made without regard to the catch-up limits.[1]

A SIMPLE 401(k) plan must satisfy a universal availability requirement for availability of catch-up contributions (Q 3706).[2]

Under the matching formula option for SIMPLE 401(k) plans, the employer must match employee salary deferral contributions dollar-for-dollar up to 3 percent of the employee's compensation.[3] (Earlier guidance stated that matching of catch-up contributions was not required).[4]

Under the second option, the employer makes a contribution of 2 percent of compensation on behalf of each employee who is eligible to participate and who has at least $5,000 in compensation from the employer for the year, provided notice of the election is given prior to the sixty day election period.[5]

The plan also must provide that no other contributions may be made to the plan other than those described above.[6] This is the "exclusive plan requirement."

All contributions to a SIMPLE 401(k) plan must be nonforfeitable.[7] This requirement is met if no contributions were made, or no benefits accrued, for services during the year under any qualified plan of the employer on behalf of any employee eligible to participate in the cash or deferred arrangement, other than the contributions made to the SIMPLE 401(k) plan.[8] The receipt of a reallocation of forfeitures under another plan of the employer will not cause a SIMPLE 401(k) participant to violate this requirement.[9]

Employees generally must have the right to terminate participation at any time during the year, although the plan may preclude the employee from resuming participation until the beginning of the next year.[10] Furthermore, each employee eligible to participate must have sixty days before the first day of any year (and sixty days before the first day the employee is eligible to participate) to elect whether to participate in the plan or to modify his or her deferral amount. The foregoing requirements are met only if the employer notifies each eligible employee of such rights within a reasonable time before the sixty day election period.[11]

A SIMPLE 401(k) plan that meets the requirements set forth in IRC Section 401(k)(11) is not subject to the top-heavy rules (Q 3818) provided that the plan allows only the

1. IRC Sec. 414(v)(2)(A); Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
2. IRC Sec. 414(v)(3)(B); Treas. Reg. §1.414(v)-1(e).
3. Treas. Reg. §1.401(k)-4(e)(3).
4. See REG-142499-01, 66 Fed. Reg. 53555 (Oct. 23, 2001).
5. IRC Sec. 401(k)(11)(B)(ii); Treas. Reg. §1.401(k)-4(e)(4).
6. IRC Sec. 401(k)(11)(B)(i)(III); Treas. Reg. §1.401(k)-4(e)(1).
7. IRC Sec. 401(k)(11)(A)(iii).
8. IRC Sec. 401(k)(11)(C); Treas. Reg. §1.401(k)-4(c).
9. Treas. Reg. §1.401(k)-4(c)(2).
10. Treas. Reg. §1.401(k)-4(d)(2)(iii).
11. IRC Secs. 401(k)(11)(B)(iii), 408(p)(5)(B), 408(p)(5)(C); Treas. Reg. §1.401(k)-4(d)(3).

contributions required under IRC Section 401(k)(11).[1] SIMPLE 401(k) plans are subject to the other qualification requirements of a 401(k) plan, including the $260,000 compensation limit (as indexed for 2014, up from $255,000 in 2013), the IRC Section 415 limits (Q 3677, Q 3784), and the prohibition on state and local governments operating a 401(k) plan (Q 3698).[2] The IRC Section 404(a) limit on the deductibility of contributions to 25 percent of compensation (Q 3695) is increased in the case of SIMPLE 401(k) plans to the greater of 25 percent of compensation or the amount of contributions required under IRC Section 401(k)(11)(B).[3]

3716. What are the requirements for a Roth 401(k) feature?

A Roth 401(k) feature combines certain advantages of the Roth IRA with the convenience of 401(k) plan elective deferral-style contributions. The IRC states that if a qualified plan trust or a Section 403(b) annuity includes a qualified Roth contribution program, contributions to it that are so designated by the employee, although not being excluded from the employee's taxable income, will be treated as an elective deferral for plan qualification purposes.[4] A qualified plan or Section 403(b) plan will not be treated as failing to meet any qualification requirement merely on account of including a qualified Roth contribution program.[5] The Roth 401(k) provisions were implemented by EGTRRA 2001 for plan years beginning on or after January 1, 2006, and were made permanent by PPA 2006.[6]

A qualified Roth contribution program means a program under which an employee may elect to make designated Roth contributions in lieu of all or a portion of elective deferrals that the employee is otherwise eligible to make.[7] For this purpose, a designated Roth contribution is any elective deferral that would otherwise be excludable from the gross income of the employee, but that the employee designates as not being excludable.[8] Final regulations set forth the following requirements for designated Roth contributions:

(1) The contribution must be designated irrevocably by the employee at the time of the cash or deferred election as a designated Roth contribution that is being made in lieu of all or a portion of the pre-tax elective contributions the employee is otherwise eligible to make under the plan;

(2) The contribution must be treated by the employer as includable in the employee's gross income at the time the employee would have received the amount in cash, if the employee had not made the cash or deferred election (i.e., it must be treated as wages subject to applicable withholding requirements); and

(3) The contribution must be maintained by the plan in a separate account, as provided under additional requirements set forth below.[9]

1. IRC Sec. 401(k)(11)(D)(ii); Treas. Reg. §1.401(k)-4(h).
2. Rev. Proc. 97-9, 1997-1 CB 624; Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
3. IRC Sec. 404(a)(3)(A)(ii).
4. As defined in IRC Sec. 402(g).
5. IRC Secs. 402A(a), 402A(e)(1).
6. See P.L. 109-280, Sec. 811.
7. IRC Sec. 402A(b)(1).
8. IRC Sec. 402A(c)(1).
9. Treas. Reg. §1.401(k)-1(f)(1).

A plan with a Roth contribution must provide for separate accounts for the designated Roth contributions of each employee and any earnings allocable to the account.[1] Gains, losses, and other credits and charges associated with the Roth accounts must be separately allocated on a reasonable and consistent basis to the designated Roth account and other accounts under the plan. Forfeitures of any accounts may not be reallocated to the designated Roth account. No contributions other than designated Roth contributions and rollover Roth contributions (as described below) may be allocated to the Roth account. The separate accounting requirement applies from the time the designated Roth contribution is made until the designated Roth contribution account is completely distributed.[2]

The maximum amount an employee may claim as a designated Roth contribution is limited to the maximum amount of elective deferrals permitted for the tax year, reduced by the aggregate amount of elective deferrals for the tax year for which no designation is made.[3] Only one limit can be split between the Roth and salary deferrals of the employee each calendar year.

Designated Roth contributions generally must satisfy the rules applicable to elective deferral contributions. Thus, for example, the nonforfeitability requirements and distribution limitations of Treasury Regulation §1.401(k)-1(c) and (d) must be satisfied for Roth contributions. Designated Roth contributions are treated as elective deferral contributions for purposes of the actual deferral percentage ("ADP") test.[4]

A designated Roth account is subject to the minimum distribution requirements of IRC Section 401(a)(9) (Q 3801 to Q 3813).[5] A payment or distribution otherwise allowable from a designated Roth account may be rolled over to another designated Roth account of the individual from whose account the payment or distribution was made or to a Roth IRA of the individual.[6] Rollover contributions to a designated Roth account under this provision are not taken into account for purposes of the limit on designated Roth contributions.[7] Funds in a Roth IRA are not subject to the lifetime minimum distribution requirements that apply to Roth accounts in a qualified plan (Q 3637).

The IRC states that any qualified distribution from a designated Roth account is excluded from gross income.[8] A qualified distribution for this purpose is defined in the same manner as for Roth IRAs except that the provision for "qualified special purpose distributions" is disregarded (Q 3626).[9] The term qualified distribution does not include distributions of excess deferrals (amounts in excess of the IRC Section 402(g) limit) or excess contributions (under IRC Section 401(k)(8)), or any income on them.[10]

1. IRC Sec. 402A(b)(2).
2. Treas. Reg. §1.401(k)-1(f)(2).
3. IRC Sec. 402A(c)(2).
4. See Treas. Reg. §1.401(k)-1(f)(3).
5. Treas. Reg. §1.401(k)-1(f)(3).
6. IRC Sec. 402A(c)(3).
7. See IRC Sec. 402(A(c)(3)(B).
8. IRC Sec. 402A(d)(1).
9. IRC Sec. 402A(d)(2)(A). See IRC Section 408A(d)(2)(A)(iv).
10. IRC Sec. 402A(d)(2)(C).

Nonexclusion period. A payment or distribution from a designated Roth account will not be treated as a qualified distribution if it is made within the five-year nonexclusion period. This period begins with the earlier of (1) the first taxable year for which the individual made a designated Roth contribution to any designated Roth account established for that individual under the same retirement plan, or (2) if a rollover contribution was made to the designated Roth account from another designated Roth account previously established for the individual under another retirement plan, the first taxable year for which the individual made a designated Roth contribution to the previously established account.[1]

The IRC states that notwithstanding IRC Section 72, if any excess deferral attributable to a designated Roth contribution is not distributed on or before the first April 15 after the close of the taxable year in which the excess deferral was made, the excess deferral will not be treated as investment in the contract and will be included in gross income for the taxable year in which such excess is distributed.[2] Furthermore, it adds that "Section 72 shall be applied separately with respect to distributions and payments from a designated Roth account and other distributions and payments from the plan."[3]

Planning Point: Even though designated Roth contributions are not excluded from income when contributed, they are treated as elective deferrals for purposes of IRC Section 402(g). Thus, to the extent total elective deferrals for the year exceed the 402(g) limit for the year, the excess amount can be distributed by April 15th of the year following the year of the excess without adverse tax consequences. However, if the excess deferrals are not distributed by that time, any distribution attributable to an excess deferral that is a designated Roth contribution is includible in gross income (with no exclusion from income for amounts attributable to basis under Section 72) and is not eligible for rollover. If there are any excess deferrals that are designated Roth contributions that are not corrected prior to April 15th of the year following the excess, the first amounts distributed from the designated Roth account are treated as distributions of excess deferrals and earnings until the full amount of those excess deferrals (and attributable earnings) are distributed.[4]

3717. How are qualified distributions from a designated Roth 401(k) or 403(b) account taxed?

A designated Roth account is an option that is available under a 401(k) or a 403(b) plan to which designated Roth contributions (Q 3716) are made.[5] Where the designated Roth account satisfies certain requirements (referred to as "qualified distributions"), distributions from the account are free of income tax, even if not rolled over. For details on the requirements of a Roth 401(k) feature, see Q 3716.

Qualified distributions. The taxation of a distribution from a designated Roth account depends on whether the distribution constitutes a qualified distribution. A qualified distribution generally

1. IRC Sec. 402A(d)(2)(B).
2. IRC Sec. 402A(d)(3).
3. IRC Secs. 402A(d)(3), 402A(d)(4).
4. TD 9324, 2007-2 IRB (May 29, 2007).
5. See IRC Sec. 402A(b)(2)(A); Treas. Reg. §1.402A-1, A-1.

is a distribution received after a five-taxable-year period that meets any of the following qualified purposes for this rule:

(1) it is made after the employee reaches age 59½,

(2) it is attributable to the employee's being disabled within the meaning of IRC Section 72(m)(7),

(3) it is made after the employee's death, or

(4) is a qualified reservist distribution.[1]

This definition is the same as that used for Roth IRAs except that the provision for "qualified special purpose distributions" is disregarded (Q 3626).[2]

The term qualified distribution does not include distributions of excess deferrals that arise in correction of either an excess deferral under the IRC Section 402(g) limit or an excess contribution under IRC Section 401(k)(8), or any income attributable to such a distribution.[3]

3718. How are nonqualified distributions from a designated Roth 401(k) or 403(b) account taxed?

A nonqualified distribution from a designated Roth account generally is partially nontaxable. The portion of the distribution that constitutes the employee contribution is not taxable, and the portion that relates to earnings on those contributions is taxable.[4] A nonqualified distribution may be rolled over to a Roth IRA. The funds in a designated Roth account are not subject to the ordering rules that determine the tax treatment of Roth IRA distributions (Q 3626) unless they are rolled over to a Roth IRA.[5]

The preamble to the proposed regulations illustrated the pro rata treatment of nonqualified distributions as follows: If a nonqualified distribution of $5,000 is made from an employee's designated Roth account when the account consists of $9,400 of designated Roth contributions and $600 of earnings, the distribution consists of $4,700 of designated Roth contributions (that are not includible in the employee's gross income) and $300 of earnings (that are includible in the employee's gross income).

Amounts not treated as qualified. Certain amounts that are not eligible rollover distributions cannot be treated as qualified distributions at any time, and always will be currently includible in income. These include corrective distributions of excess deferrals and excess contributions (Q 3733), deemed distributions resulting from violations of the plan loan requirements (Q 3849), and the cost of current life insurance protection (Q 3843).[6]

1. See IRC Sec. 402A(d)(1), Treas. Reg. §1.402A-1, A-2. See also Notice 2010-84.
2. IRC Sec. 402A(d)(2)(A). See IRC Sec. 408A(d)(2)(A)(iv).
3. IRC Sec. 402A(d)(2)(C).
4. See Treas. Reg. §1.402A-1, A-3; IRC Sec. 72(e)(8).
5. See Treas. Reg. §1.408A-10, A-1.
6. See Treas. Regs. §§1.402(g)-1(e)(8)(iv), 1.402A-1, A-2(c), 1.402A-1, A-11.

3719. How is the five-year holding period required of qualified distributions from designated Roth 401(k) or 403(b) accounts determined?

Distributions from a designated Roth account satisfy the five-year requirement to be a "qualified distribution" when the following conditions are met. For this purpose, a Roth contribution is deemed to be made on the first day of the first taxable year for which the employee first made any designated Roth contributions. Thus, for a calendar year plan, all contributions in the first year would be deemed made on January 1 of that year. Starting with that date, the five year period ends at the end of the fifth consecutive taxable year following that date.

If an employee makes deferrals to designated Roth accounts under more than one plan, the employee will have two or more separate five year periods of participation that are calculated independently of one another unless the employee receives a direct rollover of a Roth distribution from another plan.[1] This calculation differs from the five year period calculation under a Roth IRA in which the five year period starts with the date a Roth contribution was made to any Roth IRA (Q 3626).

3720. Can the owner of a designated Roth 401(k) or 403(b) account roll those funds into another retirement account?

A rollover of a designated Roth account distribution that is not includable in income may be made only to another designated Roth account of the individual from whose account the payment or distribution was made or to a Roth IRA of the individual either through a sixty day rollover or a direct rollover. A plan receiving a designated Roth account rollover must agree to separately account for the amount that is not includable in income. Furthermore, if such a rollover is made to another plan, it must be made as a direct rollover to assure that there is proper accounting in the recipient plan. In other words, a rollover to a plan is not available if the distribution has been made directly to the employee. In that case, however, an employee would have the option of rolling over the distribution to a Roth IRA within sixty days.[2]

If a rollover is made from a designated Roth account under another plan, the five year period for the receiving plan begins on the first day that the employee made designated Roth contributions to the other plan, if earlier.[3]

If a rollover is made from a designated Roth account to a Roth IRA, the period that the rolled over funds were in the designated Roth account does not count toward the five taxable year period for determining qualified distributions from the Roth IRA. If the Roth IRA was established in an earlier year, the five year period for determining qualified distributions from the Roth IRA applies to distributions of rolled over amounts.[4] Furthermore, the entire amount of any qualified distribution rolled over to a Roth IRA is treated as basis in the Roth IRA.

1. Treas. Reg. §1.402A-1, A-4.
2. See IRC Sec. 402A(c)(3); Treas. Reg §1.402A-1, A-5.
3. Treas. Reg. §1.402A-1, A-4(b).
4. Treas. Reg. §1.408A-10, A-4.

As a result, a subsequent distribution from the Roth IRA of that amount would not be includable in the owner's gross income.[1]

3721. What is the separate accounting requirement applicable to a designated Roth 401(k) or 403(b) account?

Proposed regulations state that "any transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account" will have the effect of violating the separate accounting requirement. A transaction that merely exchanges investments between accounts at fair market value will not violate the separate accounting requirement.[2]

3722. What in-plan rollovers are permitted with respect to designated Roth 401(k) or 403(b) accounts?

The IRS issued guidance on changes to Section 402A made as a result of the Small Business Jobs Act of 2010 ("SBJA"),[3] which added Section 402A(c)(4), allowing rollovers from Section 401(k) plans to designated Roth accounts in the same plan ("in-plan Roth rollovers"). Section 402A(c)(4) applies to distributions made after September 27, 2010. The rollover may be accomplished by a direct rollover or a sixty day rollover.[4]

In-plan Roth direct rollovers are not treated as a distribution for situations involving plan loans, spousal annuities, participant consent before an immediate distribution of an accrued benefit in excess of $5,000, and elimination of optional forms of benefit.[5]

A qualified distribution is included in gross income as if it were not rolled over to a designated Roth account. The taxable amount of the in-plan Roth rollover must be included in the participant's gross income. The taxable amount of an in-plan Roth rollover is the amount that would be includible in a participant's gross income if the rollover were made to a Roth IRA. This amount is equal to the fair market value of the distribution reduced by any basis the participant has in the distribution.[6] The taxable amount of a distribution that an individual rolls over in an in-plan Roth rollover generally is includible in gross income in the taxable year in which the distribution occurs.

For such distributions made in taxable years beginning in 2010, unless the individual elects to include the taxable amount of the distribution in gross income for the taxable year beginning in 2010, the taxable amount of the distribution is includible half in the taxable year beginning in 2011 and half in the taxable year beginning in 2012.[7]

1. See Treas. Reg. §1.408A-10, A-3(a).
2. Treas. Regs. §1.402A-1, A-13(a).
3. P.L. 111-240, Sec. 2112.
4. IRS Notice 2010-84, Q&A-1.
5. IRS Notice 2010-84, Q&A-4.
6. See Notice 2009-75, 2009-35 I.R.B. 436.
7. IRS Notice 2010-84.

A rollover to a Roth IRA can be unwound; an in-plan rollover cannot be unwound because the recharacterization rule in Section 408A(d)(6) applies only to contributions to IRAs.[1] In-plan Roth direct rollovers are not subject to the otherwise mandatory 20 percent withholding.[2] A written explanation must be provided to the participant.[3]

3723. What are the new rules that expand the use of 401(k) to Roth 401(k) rollovers?

The American Taxpayer Relief Act of 2012 (ATRA) now permits rollovers of funds (even if they are not otherwise distributable without penalty) from traditional 401(k) accounts into Roth 401(k) accounts without a penalty tax. Prior to this expansion, only 401(k) funds that could otherwise be distributed from a 401(k) on a penalty-free basis (for example, funds distributed after the taxpayer reached age 59½ or became disabled)[4] could be rolled over.

ATRA does not limit the amount that a plan participant can roll over. Any amount rolled over pursuant to this provision is treated as a distribution that was contributed in a qualified rollover contribution within the meaning of IRC Section 408A. This provision may be adopted by 401(k) plans, 403(b) plans and governmental 457(b) plans for tax years beginning after 2012.[5]

As under prior law, the amount that is rolled over from a traditional 401(k) into a Roth 401(k) is included in gross income. The taxable amount of the Roth rollover must be included in the participant's gross income. The taxable amount of an in-plan Roth rollover is the amount that would be includible in a participant's gross income if the rollover were made to a Roth IRA. This amount is equal to the fair market value of the distribution reduced by any basis the participant has in the distribution.[6] The taxable amount of a distribution that an individual rolls over in an in-plan Roth rollover generally is includible in gross income in the taxable year in which the rollover occurs.

The expanded rollover treatment is optional, so that plan administrators have discretion as to whether to adopt an amendment permitting expanded use of this type of rollover. The IRS has provided that such an amendment must be made by the later of (1) the last day of the first plan year that the amendment is effective or (2) December 31, 2014.[7]

See Q 3724 for distribution restrictions that apply following a 401(k) to Roth 401(k) rollover.

3724. Are amounts rolled over to a Roth 401(k) subject to distribution restrictions after the rollover?

Yes. Though the American Taxpayer Relief Act of 2012 expanded the rules governing rollovers from traditional 401(k) accounts to Roth 401(k) accounts to allow rollovers of otherwise

1. IRS Notice 2010-84, Q&A-6.
2. IRS Notice 2010-84, Q&A-8.
3. IRS Notice 2010-84, Q&A-5.
4. IRC Sec. 401(k)(2)(B).
5. American Taxpayer Relief Act of 2012, Pub. Law No. 112-240, Sec. 902.
6. Notice 2009-75, 2009-35 IRB 436; Notice 2010-84, 2010-51 IRB 872.
7. Notice 2013-74, 2013-52 IRB 819.

nondistributable amounts, the IRS has issued guidance providing that distribution restrictions will now apply after such amounts are rolled over.

Any amount that is rolled over from a traditional 401(k) to a Roth 401(k) remains subject to the same distribution restrictions that applied to the amounts before the rollover.[1] As a result, if an individual makes a rollover from a traditional 401(k) to a Roth 401(k) before reaching age 59½, for example, the rolled over amounts cannot be withdrawn from the Roth 401(k) on a penalty-free basis unless one of the other events described in IRC Section 401(k)(2)(B) has occurred (i.e., unless he or she reaches age 59½ or there has been a separation from service, death or disability).

3725. Are otherwise nondistributable amounts that are rolled over from a 401(k) to a Roth 401(k) subject to withholding?

The withholding requirements of IRC Section 3405 do not apply to otherwise nondistributable amounts that are rolled over from a traditional 401(k) into a Roth 401(k) because such a rollover must be accomplished through a direct rollover.[2]

Further, because a nondistributable rollover cannot, by definition, be distributed to the taxpayer, a taxpayer is not permitted to voluntarily elect that a portion of the distribution be subject to withholding for purposes of meeting the taxpayer's tax obligations with respect to the rollover. As a result, IRS guidance specifically advises that a taxpayer who elects to roll 401(k) funds into a Roth 401(k) may wish to increase withholding or make estimated payments in order to avoid an underpayment penalty.[3]

3726. Can a plan restrict the types of 401(k) contributions that can be converted to a Roth 401(k)?

Yes. A plan that adopts an amendment permitting in-plan rollovers from traditional 401(k) accounts to Roth 401(k) accounts can, subject to otherwise applicable nondiscrimination requirements, restrict the types of contributions that can be rolled over. Further, the plan amendment can limit the frequency of these rollovers.[4]

For example, while the American Taxpayer Relief Act of 2012 has expanded the use of 401(k) to Roth 401(k) rollovers so that otherwise nondistributable amounts may be permissibly rolled over, it is up to the plan itself to determine whether it will allow these rollovers. For administrative convenience, a plan may provide that it will only permit rollovers of otherwise distributable amounts or that nondistributable amounts can only be rolled over at certain intervals.

3727. What is an eligible investment advice arrangement?

ERISA contains a general prohibition against providing services to a plan for a fee. It is a prohibited transaction unless exempted either in the law or by regulations. There is a statutory

1. Notice 2013-74, 2013-52 IRB 819.
2. Notice 2013-74, 2013-52 IRB 819.
3. IRC Sec. 3402(p); Notice 2013-74, 2013-52 IRB 819.
4. Notice 2013-74, 2013-52 IRB 819.

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exemption for investment advice rendered by a fiduciary advisor under an "eligible investment advice arrangement." These requirements are designed to allow the plan fiduciary to meet his obligations under ERISA in the hiring of an investment advisor.[1] The provisions discussed here generally are effective with respect to advice provided after December 31, 2006.

On October 25, 2011, the Employee Benefits Security Administration of the U.S. Department of Labor issued final regulations implementing a statutory exemption from ERISA's prohibited transaction rules that allows fiduciary advisers to offer plan participants and beneficiaries investment advice for a fee under eligible investment advice arrangements.[2] The exemption, discussed below, was mandated by the Pension Protection Act of 2006 and is available for transactions occurring on or after December 27, 2011 that provide sufficient safeguards to ensure there is no conflict of interest.

The final rules do not affect the applicability of the DOL's prior guidance on the application of the prohibited transaction rules and existing prohibited transaction exemptions to investment advice arrangements.

An eligible investment advice arrangement may be established in either of two ways: (1) the arrangement may provide that any fees (including commissions or other compensation) received by the fiduciary for investment advice, or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets, do not vary depending on the basis of any investment option selected, or (2) the arrangement may use a computer model that meets specified criteria, described below, in connection with the provision of investment advice by a fiduciary adviser to a participant or beneficiary.[3]

The use of either method requires the plan fiduciary to comply with the statutory requirements of this exemption. Those requirements include:

(1) the advisor must act as an independent fiduciary,

(2) proper authorization to provide the services,

(3) compliance with an audit requirement,

(4) disclosure of all relevant information including meeting certain standards for presentation of information,

(5) the maintenance of proper records, and

(6) the fees charged the plan are reasonable.[4]

The fee leveling requirement is met if the fees, commissions, or any revenue sharing by the advisor do not vary based upon the recommendations provided. This applies to the affiliate of the advisor.[5]

1. IRC Secs. 4975(d)(17), 4975(f)(8).
2. DOL Reg. §2550.408g-1.
3. IRC Sec. 4975(f)(8)(B).
4. IRC Sec. 4975(f)(8)(D) through (I).
5. IRC Sec. 4975(f)(8)(B)(i)(I).

Computer Model

The computer model must:

(1) apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time,

(2) use relevant information about the participant, such as age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments,

(3) use prescribed objective criteria to provide asset allocation portfolios comprised of investment options offered under the plan,

(4) operate in a manner that is not biased toward investments offered by the fiduciary advisor, or a person in material affiliation or contractual relationship with the fiduciary advisor, and

(5) take into account all investment options under the plan in specifying how a participant's account should be invested and not be inappropriately weighted with respect to any investment option.[1]

The person who develops or markets the computer model or investment advice program may be treated as a fiduciary adviser under certain circumstances.[2]

The utilization of the computer model must be certified by an "eligible investment expert" as meeting the foregoing criteria, and the only advice provided under the arrangement can be that generated by the computer model and any transaction requested by the participant.[3] The arrangement also must be audited annually and must meet detailed written disclosure requirements. Records of compliance must be maintained for six years.[4]

An eligible investment advice arrangement must be expressly authorized by a plan fiduciary other than the person offering the investment advice. Notifications required for participants and beneficiaries must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant.[5] The DOL is directed to issue a model form for this purpose.[6]

Fiduciary Adviser

A "fiduciary adviser" for purposes of this provision is a person who is a fiduciary of the plan by reason of his or her provision of investment advice to the participant or beneficiary and who is one of the following:

(1) a registered investment adviser ("RIA") in the state in which the fiduciary maintains its principal office and place of business;

1. IRC Sec. 4975(f)(8)(C)(ii); DOL Reg. §2550.408g-1(b)(4).
2. IRC Sec. 4975(f)(8)(J)(i).
3. IRC Sec. 4975(f)(8)(C)(iii), 4975(f)(8)(C)(iv).
4. IRC Sec. 4975(f)(8)(I).
5. IRC Sec. 4975(f)(8)(H)(i).
6. IRC Sec. 4975(f)(8)(H)(ii).

(2) a bank or similar financial institution, but only if the advice is provided through a trust department that is subject to periodic examination and review by federal or state banking authorities;

(3) an insurance company qualified to do business under the laws of a state;

(4) a person registered as a broker or dealer under the Securities Exchange Act of 1934;

(5) an affiliate of any of the persons described in (1) through (4); or

(6) an employee, agent, or registered representative of a person described in (1) through (5) who satisfies the requirements of applicable insurance, banking, and securities laws relating to the provision of the advice.[1]

The Final Regulations

The statutory exemption allows fiduciary investment advisers to receive compensation from investment vehicles that they recommend if either (1) the investment advice is based on a computer model certified as unbiased which applies generally accepted investment theories, or (2) the adviser is compensated on a "level-fee" basis (i.e., fees do not vary based on investments selected by the participant). The final regulations provide detailed guidance to advisers on compliance with these conditions.

The regulations also show advisers how to comply with other conditions and safeguards in the statutory exemption, including:

- Requiring that a plan fiduciary (independent of the investment adviser or its affiliates) authorize the advice arrangement.
- Imposing recordkeeping requirements for investment advisers relying on the exemption.
- Requiring that computer models be certified in advance as unbiased and meeting the exemption's requirements by an independent expert.
- Establishing qualifications and a selection process for the investment expert who must perform the above certification.
- Clarifying that the level-fee requirement does not permit investment advisers (including their employees) to receive compensation from any party (including affiliates) that varies on the basis of the investments that participants select.
- Establishing an annual audit of both computer model and level-fee advice arrangements, including the requirement that the auditor be independent from the investment advice provider.
- Requiring disclosures by advisers to plan participants.[2]

1. IRC Sec. 4975(f)(8)(J)(i); DOL Reg. §2550.408g-1(c)(2)(i).
2. DOL Reg. §2550.408g-1.

Fee Disclosures

In February 2012, the DOL issued final regulations on fee disclosure[1] and provided a Sample Guide to Initial Disclosures.[2] In its final rule, the DOL extended the deadline for disclosures to July 1, 2012. In May 2012, the DOL issued a Field Assistance Bulletin providing guidance on frequently asked questions about participant-level disclosure requirements.[3]

3728. What is a combination defined benefit/401(k) plan?

For plan years beginning after December 31, 2009, an "eligible combined plan" (i.e., a combination defined benefit/401(k) plan) is available to employers with two to 500 employees.[4]

The assets of the plan will be held in a single trust, and the defined benefit and 401(k) components generally will be subject to their already-existing qualification requirements. The plan will be required to file only one Form 5500 and will have a single plan document.[5] The top heavy rules (Q 3817 to Q 3823) will be deemed satisfied for a combined defined benefit/401(k) plan, and the 401(k) portion will be exempt from ADP/ACP testing (Q 3698, Q 3731).[6]

The plan's design generally will be subject to the following requirements:

(1) The benefit requirement for the defined benefit portion will be satisfied if the annual accrued benefit of each participant is not less than 1 percent of final average pay times up to twenty years of service, or if the plan is a cash balance plan providing pay credits not less than the percentage of compensation determined under the following formula:

Participant's age as of beginning of year	Cash balance pay credit percentage of compensation
30 or less	2
30 or over, less than 40	4
40 or over, less than 50	6
50 or over	8

For this purpose, "final average pay" is determined using up to five years during which the participant had the highest aggregate compensation from the employer.[7]

(2) The contribution requirement will be met if the 401(k) plan provides for an automatic contribution arrangement (see below) and requires the employer to match

1. DOL Reg. §2550.408b-2.
2. Available at http://www.dol.gov/ebsa/pdf/408b2sampleguide.pdf (Feb. 12, 2012).
3. Field Assistance Bulletin 2012-2 (May 7, 2012).
4. IRC Sec. 414(x)(2)A); IRC Sec. 4980D(d)(2).
5. See IRC Secs. 414(x)(2), 414(x)(6).
6. IRC Secs. 414(x)(3), 414(x)(4).
7. IRC Sec. 414(x)(2)(B).

50 percent of elective deferrals of up to 4 percent of compensation.[1] Nonelective contributions are not precluded but will not count toward satisfying this requirement.[2]

(3) Employees must be 100 percent vested after three years of service with respect to the defined benefit portion of the plan. Matching contributions under the defined contribution portion must be nonforfeitable, including those in excess of the required match. Any nonelective contributions may be subject to a maximum three-year cliff vesting schedule.[3]

(4) All contributions, benefits, rights, and features must be provided uniformly to all participants;[4] and

(5) The foregoing requirements must be met without taking into account permitted disparity and amounts under other plans.[5]

These criteria are the only circumstances under which a combination defined benefit/401(k) plan may constitute a single plan and trust.

A 401(k) plan will be treated as an automatic contribution arrangement if it provides a default elective contribution percentage of 4 percent and meets specific notice requirements. Employees must receive a notice explaining their right not to have contributions withheld, or to have them made at a different rate, and they must have a reasonable period of time after receipt of the notice to make such elections.[6]

3729. What restrictions apply to distributions from 401(k) plans?

Amounts held by the trust that are attributable to employer contributions made pursuant to the election to defer may not be distributed to participants or beneficiaries prior to:

(1) the employee's death, disability, or severance from employment;

(2) certain plan terminations, without the establishment or maintenance of another defined contribution plan;

(3) in the case of a profit sharing or stock bonus plan, the employee's reaching age 59½ or experiencing financial hardship (Q 3730); or

(4) in the case of a qualified reservist distribution, the date of the reservist's order or call.[7]

The final regulations cited here were published in December 2004 and are effective for plan years beginning on or after January 1, 2006.[8]

1. IRC Sec. 414(x)(2)(C).
2. IRC Sec. 414(x)(2)(C)(ii).
3. IRC Sec. 414(x)(2)(D).
4. IRC Sec. 414(x)(2)(E).
5. See IRC Sec. 414(x)(2)(F).
6. See IRC Sec. 414(x)(5).
7. See IRC Sec. 72(t)(2)(G)(iii); Q 3629. See IRC Sec. 401(k)(2)(B)(1); Treas. Reg. §1.401(k)-1(d)(1).
8. See Treas. Reg. §1.401(k)-1(g).

These occurrences are referred to as "distributable events." Amounts may not be distributable merely by reason of completion of a stated period of participation or the lapse of a fixed number of years.[1] A qualified hurricane distribution (Q 540) will be treated as satisfying the distribution requirements of IRC Section 401(k)(2)(B).[2]

The cost of life insurance protection as per Table 2001 or P.S. 58 costs (Q 3843) provided under the plan is not treated as a distribution for purposes of these rules. Neither is the making of a loan that is treated as a deemed distribution even if the loan is secured by the employee's elective contributions or is includable in the employee's income under IRC Section 72(p).

The reduction of an employee's accrued benefit derived from elective contributions (i.e., an offset distribution) by reason of a default on a loan is treated as a distribution (Q 3848).[3] The IRS has privately ruled that a transfer of 401(k) elective deferrals or rollovers to purchase service credits would not constitute an impermissible distribution from the plan and are not a violation of the separate accounting requirement.[4]

Restrictions on distributions of elective contributions generally continue to apply even if the amounts are transferred to another qualified plan of any employer.[5] Amounts transferred to a 401(k) plan by a direct rollover from another plan do not have to be subject to these restrictions.[6] See Q 3717 for discussion of in-plan Roth distributions. See Q 3723 for a discussion of penalty-free rollovers from 401(k) plan accounts into Roth 401(k) accounts under the American Taxpayer Relief Act of 2012. Final regulations state that rollover amounts may be excepted from the timing restrictions on distributions applicable to a receiving plan, provided there is a separate accounting for such amounts.[7]

If an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan, distributions of those amounts are not subject to the restrictions on permissible timing that apply, under the applicable requirements of the Internal Revenue Code to distributions of other amounts from the plan. Accordingly, the plan may permit the distribution of amounts attributable to rollover contributions at any time pursuant to an individual's request.

Thus, for example, if the receiving plan is a money purchase pension plan and the plan separately accounts for amounts attributable to rollover contributions, a plan provision permitting the in-service distribution of those amounts will not disqualify the plan.[8]

3730. What requirements apply to hardship withdrawals from a 401(k) plan?

Hardship withdrawals may be made from a 401(k) plan only if the distribution is made on account of an immediate and heavy financial need and the distribution is necessary to satisfy the

1. IRC Sec. 401(k)(2)(B).
2. IRC Sec. 1400Q(a)(6)(B).
3. Treas. Reg. §1.401(k)-1(d)(5)(ii).
4. Let. Ruls. 200335035, 199914055.
5. Treas. Reg. §1.401(k)-1(d)(2).
6. Treas. Reg. §1.401(k)-1(d)(5)(iv).
7. Treas. Reg. §1.401(k)-1(d)(5)(iv); see also Rev. Rul. 2004-12, 2004-7 IRB 478.
8. Rev. Rul. 2004-12, 2004-7 IRB.

financial need.[1] The distribution may not exceed the employee's maximum distributable amount. Hardship withdrawals generally may not be rolled over (Q 3882).[2] The final regulations cited here took effect for plan years beginning on or after January 1, 2006.[3]

The Pension Protection Act of 2006 called for regulations modifying the hardship requirements to state that if an event constitutes a hardship with respect to a participant's spouse or dependent, it constitutes a hardship with respect to the participant, to the extent permitted under the plan.[4]

An employee's maximum distributable amount generally is equal to the employee's total elective contributions as of the date of distribution reduced by the amount of previous distributions on account of hardship.[5]

The determinations of whether the participant has "an immediate and heavy financial need" and whether other resources are "reasonably available" to meet the need are to be made on the basis of all relevant facts and circumstances. An example of "an immediate and heavy financial need" is the need to pay funeral expenses of a family member. A financial need will not fail to qualify as an immediate and heavy financial need merely because it was foreseeable or voluntarily incurred by the employee.[6]

A distribution will be deemed to be made on account of "an immediate and heavy financial need" if it is made on account of any of the following:

(1) "medical expenses" incurred by the employee, spouse, or dependents;

(2) the purchase (excluding mortgage payments) of the employee's principal residence;

(3) payment of tuition, related educational fees, and room and board expenses for the next twelve months of post-secondary education for the employee, spouse, children, or dependents;

(4) payments necessary to prevent eviction of the employee from his or her principal residence or foreclosure on the mortgage on his or her principal residence;

(5) for plan years beginning on or after January 1, 2005, funeral or burial expenses for the employee's parent, spouse, children, or other dependents (as defined prior to 2005); and

(6) expenses for the repair or damage to the employee's principal residence that would qualify for the casualty deduction under IRC Section 165 (without regard to the 10 percent floor).[7]

1. Treas. Reg. §1.401(k)-1(d)(3)(i).
2. IRC Sec. 402(c)(4). See also IRC Sec. 401(k)(2)(B).
3. See Treas. Reg. §1.401(k)-1(g).
4. See Pub. L. 109-280, Sec. 826.
5. Treas. Reg. §1.401(k)-1(d)(3)(ii).
6. Treas. Reg. §1.401(k)-1(d)(3)(iii)(A).
7. Treas. Reg. §1.401(k)-1(d)(3)(iii)(B).

This list may be expanded by the IRS but only by publication of documents of general applicability.[1] Apparently, to be the taxpayer's "principal residence" for this purpose, the home must be the residence of the employee, not merely that of his or her family.[2]

A distribution is not necessary to satisfy such an immediate and heavy financial need (and will not qualify as a hardship withdrawal) to the extent the amount of the distribution exceeds the amount required to relieve the financial need. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.[3]

The distribution also will not be treated as necessary to satisfy an immediate and heavy financial need to the extent the need can be satisfied from other resources that are reasonably available. A distribution may be treated as necessary if the employer reasonably relies on the employee's written representation that the need cannot be relieved:

(1) through reimbursement or compensation by insurance or otherwise,

(2) by reasonable liquidation of the employee's assets,

(3) by cessation of elective contributions or employee contributions,

(4) by other distributions or nontaxable loans from any plans, or

(5) by loans from commercial sources.

Notwithstanding these provisions, an employee need not "take counterproductive actions" (such as a plan loan that might disqualify the employee from obtaining other financing) if the effect would be to increase the amount of the need.[4]

Regulations state that a distribution will be deemed to be "necessary" to meet a financial need (deemed or otherwise) if the employee has obtained all other distributions and nontaxable loans currently available under all of the employer's plans and the employee is prohibited from making elective contributions and employee contributions to the plan and all other plans of the employer for a period of at least six months after receipt of the hardship distribution.[5]

3731. How does a 401(k) plan satisfy the nondiscrimination in amount requirement?

A cash or deferred arrangement will be treated as meeting the nondiscrimination requirement of IRC Section 401(a)(4) if it satisfies the actual deferral percentage ("ADP") test.[6] A plan can satisfy the ADP test by annually meeting the requirements of the ADP test itself (as explained

1. Treas. Reg. §1.401(k)-1(d)(3)(v).
2. See ABA Joint Committee on Employee Benefits, Meeting with IRS and Department of Treasury Officials, May 7, 2004 (Q&A-18).
3. Treas. Reg. §1.401(k)-1(d)(3)(iv)(A).
4. Treas. Reg. §1.401(k)-1(d)(3)(iv)(C), (D).
5. Treas. Reg. §1.401(k)-1(d)(3)(iv)(E).
6. IRC Sec. 401(k)(3)(C).

below), by satisfying the design-based requirements for a SIMPLE 401(k) plan (Q 3715), or by satisfying the design-based requirements for a safe harbor plan (Q 3710).[1]

In plan years beginning after December 31, 2007, a "qualified automatic contribution arrangement" will satisfy the ADP test requirement (Q 3707).[2] The final regulations cited here took effect for plan years beginning on or after January 1, 2006.[3]

A plan will not be treated as violating the ADP test merely on account of the making of (or right to make) catch-up contributions by participants age fifty or over under the provisions of IRC Section 414(v) so long as a universal availability requirement is met (Q 3706).[4]

Salary reductions that give rise to the saver's credit (Q 3607) may be taken into account for purposes of satisfying the ADP test.[5] If the plan provides for employee after-tax contributions or employer matching contributions, those contributions must meet the requirements of IRC Section 401(m) (Q 3732). If the plan includes a profit sharing component (i.e., nonelective contributions that are not QNECs, other than as part of one of the designs explained in Q 3715 and Q 3710), that portion of the plan will be subject to nondiscrimination in amount testing (Q 3764).

A cash or deferred arrangement in which all of the eligible employees for a plan year are highly compensated employees (Q 3827) will be deemed to satisfy the ADP test for the plan year.[6] A 401(k) plan also is subject to age and service, coverage, and other requirements (Q 3698).

Final regulations treat all governmental plans (within the meaning of IRC Section 414(d)) as meeting the coverage and nondiscrimination requirements.[7] The IRC states that state and local governmental plans, to the limited extent that they are eligible to offer a cash or deferred arrangement (Q 3698), meet the requirements of IRC Section 401(k)(3).[8] Under earlier guidance, plans established and maintained for its employees by the federal government or by any agency or instrumentality of it, are treated as meeting the requirements of IRC Section 401(k)(3) until the first day of the first plan year beginning on or after the date final regulations were issued (Dec. 29, 2004).[9]

Actual Deferral Percentage Test

The actual deferral percentage test requires that the actual deferral percentage ("ADP") of eligible highly compensated employees (Q 3827) be compared to the ADP of all other eligible employees, and that it satisfy one of the following tests:

Test 1: The actual deferral percentage for eligible highly compensated employees (Q 3827) for the plan year does not exceed the actual deferral percentage of all other eligible employees for the preceding plan year, multiplied by 1.25, or

1. IRC Secs. 401(k)(3)(A)(ii), 401(k)(11)(A), 401(k)(12)(A); Treas. Reg. §1.401(k)-1(b)(1).
2. IRC Sec. 401(k)(13).
3. Treas. Reg. §1.401(k)-1(g).
4. IRC Sec. 414(v)(3)(B).
5. Ann. 2001-106, 2001-44 IRB 416, A-10.
6. Treas. Reg. §1.401(k)-2(a)(1)(ii).
7. Treas. Reg. §1.401(k)-1(b)(2).
8. IRC Sec. 401(k)(3)(G); see Notice 2001-46, 2001-2 CB 122, as modified by Notice 2003-6, 2003-3 IRB 298.
9. Notice 2003-6, above; T.D. 9169, 69 FR 78154.

Test 2: The actual deferral percentage for eligible highly compensated employees for the plan year does not exceed by more than 2 percent that of all other eligible employees for the preceding plan year and the actual deferral percentage for highly compensated employees for the plan year is not more than the actual deferral percentage of all other eligible employees for the preceding plan year multiplied by two.

The IRC provides two methods of applying the ADP test: a prior year testing method, and a current year testing method. The foregoing method is the prior year testing method (as set forth in the IRC), but the current year method is available by election.[1] Under the current year testing method, the ADP results of nonhighly compensated employees for the current year (instead of the preceding year) are used in each test. The ability of plan sponsors to switch between the current and prior year testing methods is limited.[2] The plan document must reflect which testing method the plan is using for a testing year.[3]

Qualified matching contributions ("QMACs") and qualified nonelective contributions ("QNECs") are employer matching contributions and nonelective contributions, respectively, that are subject to the same nonforfeitability (Q 3698) and withdrawal restrictions (Q 3729) as elective deferral contributions. Under certain circumstances, elective contributions used to pass the ADP test may include QMACs and QNECs that are made with respect to employees eligible under the cash or deferred arrangement.[4] Specific requirements for such use are set forth in regulations.[5]

QMACs and QNECs may be used only once. In other words, contributions that are treated as elective contributions for purposes of the ADP test may not be taken into account for purposes of the ACP test under IRC Section 401(m) and are not otherwise taken into account in determining whether any other contributions or benefits are nondiscriminatory under IRC Section 401(a)(4). Similarly, QNECs that are treated as matching contributions for purposes of the ACP test may not be used to satisfy the ADP test.[6]

Calculation of Actual Deferral Percentage

The actual deferral percentage for a group of eligible employees is the average of the actual deferral ratios of employees in the group for the plan year as calculated separately for each employee and to the nearest 1/100 of 1 percent.[7]

An employee's actual deferral ratio is determined by dividing the amount of elective contributions (including amounts treated as elective contributions) made to the trust on his or her behalf for the plan year by his or her compensation for the plan year.[8] Only contributions allocated to the employee's account for the plan year and related to compensation that, but

1. See IRC Sec. 401(k)(3)(A).
2. See IRC Sec. 401(k)(3)(A); Treas. Regs. §§1.401(k)-2(c)(1)(ii),.
3. Treas. Reg. §1.401(k)-1(e)(7).
4. IRC Sec. 401(k)(3)(D)(ii).
5. See Treas. Reg. §1.401(k)-2(a)(6).
6. See Treas. Reg. §1.401(k)-2(a)(6)(vi).
7. Treas. Reg. §1.401(k)-2(a)(2)(i).
8. Treas. Reg. §1.401(k)-2(a)(3).

for the election to defer, would have been received during the plan year (or, if attributable to services performed during the plan year, within 2½ months after the close of the plan year) are considered in applying the ADP test. Designated Roth contributions (Q 3716) are treated as elective deferral contributions for purposes of the ADP test.[1]

Compensation, for purposes of calculating actual deferral percentages, generally means compensation for services performed for an employer, which is includable in gross income (Q 3783). An employer may limit the period taken into account to that portion of the plan year (or calendar year) in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees.[2]

Miscellaneous Provisions

Although a plan must, by its terms, provide that the ADP test will be met; it may incorporate by reference the 401(k) nondiscrimination provisions of the IRC and regulations.[3]

3732. What special rules apply to employer matching contributions? What rules apply to employee contributions?

A defined contribution plan that provides for employee contributions or matching contributions, typically a 401(k) plan (Q 3698), must satisfy the actual contribution percentage ("ACP") test or one of the alternatives to it, as explained below, to meet the nondiscrimination in amount requirement of IRC Section 401(a)(4).[4] With respect to matching contributions only, two alternative plan designs are available that are deemed to satisfy the ACP test: a SIMPLE 401(k) plan (Q 3715), or a safe harbor design (Q 3710).[5] In plan years beginning after December 31, 2007, a "qualified automatic contribution arrangement" will satisfy the ACP test requirement with respect to matching contributions (Q 3707).[6]

Matching contributions are subject to a three year cliff or five year graduated vesting schedule (Q 3785). The final regulations cited here took effect for plan years beginning on or after January 1, 2006.[7]

A plan will not be treated as violating the ACP test merely on account of the making of, or the right to make, catch-up contributions by participants age fifty or over under the provisions of IRC Section 414(v) so long as a universal availability requirement is met (Q 3706).[8]

All after-tax employee contributions are subject to ACP testing even if one of the design-based alternatives is used. Employee contributions for this purpose do not include designated

1. See Treas. Reg. §1.401(k)-1(f)(4).
2. Treas. Reg. §1.401(k)-6.
3. Treas. Reg. §1.401(k)-1(e)(7).
4. IRC Sec. 401(m)(1).
5. IRC Secs. 401(m)(10), 401(m)(11).
6. IRC Sec. 401(m)(12).
7. Treas. Reg. §1.401(m)-1(d).
8. IRC Sec. 414(v)(3)(B).

Roth contributions (Q 3716). The term also does not include rollover amounts, repayment of loans, or any other amounts transferred from another plan.[1]

The contributions that are required under a safe harbor plan (Q 3710) may not be used to satisfy the ACP test for after-tax employee contributions. Any employer matching or nonelective contributions in excess of the amount required to satisfy the safe harbor rules for a qualified cash or deferred arrangement can be taken into account for purposes of satisfying the ACP test.[2] Voluntary after-tax employee contributions that give rise to the saver's credit (Q 3607) may be taken into account for purposes of satisfying the ACP test.[3]

Of course, the plan must satisfy the general nondiscrimination requirements applicable to all qualified plans (Q 3764). In particular, the availability of matching and employee contributions, as well as any other benefits, rights, and features under the plan, must be nondiscriminatory (Q 3776).[4]

Actual Contribution Percentage ("ACP") Test

The IRC provides two methods of applying the ACP test: a prior year testing method, and a current year testing method.[5] The prior year method is specified in the IRC and the current year method is available by election.[6] A plan generally must specify which of these two methods it is using.[7]

Prior year testing method. Under the prior year testing method, a defined contribution plan that provides for employee or matching contributions meets the ACP test if the contribution percentage for eligible highly compensated employees for the plan year does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees for the preceding plan year, or (2) the lesser of (i) 200 percent of the contribution percentage for all other eligible employees for the preceding plan year or (ii) such contribution percentage for all other employees for the preceding plan year plus two percentage points.[8]

Current year testing method. Under the current year testing method, the ACP results of nonhighly compensated employees for the current year, also known as the "testing year," are compared with those of highly compensated employees for the current year. The plan satisfies the ACP test if the contribution percentage for eligible highly compensated employees for the plan year does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees for the plan year or (2) the lesser of (x) 200 percent of the contribution percentage for all other eligible employees for the plan year or (y) such contribution percentage for all other employees for the plan year plus two percentage points.[9]

1. Treas. Reg. §1.401(m)-1(a)(3)(ii).
2. See General Explanation of Tax Legislation Enacted in the 104th Congress (JCT-12-96), p. 153 (the 1996 Blue Book).
3. Ann. 2001-106, 2001-44 IRB 416, A-10.
4. Treas. Reg. §1.401(m)-1(a)(1)(ii).
5. Treas. Reg. §1.401(m)-1(a)(2).
6. IRC Sec. 401(m)(2)(A); Treas. Reg. §1.401(m)-2(a)(2)(ii).
7. Treas. Reg. §1.401(m)-1(c)(2).
8. IRC Sec. 401(m)(2)(A); Treas. Reg. §1.401(m)-2(a)(2)(ii).
9. IRC Sec. 401(m)(2)(A); Treas. Regs. §§1.401(m)-2(a)(1), 401(m)-2(a)(2)(ii).

A plan is not required to use the same method under the ACP test as it uses under the ADP test (Q 3731), but special rules must be followed if different methods are used.[1]

Planning Point: Make sure to accurately count highly compensated employees using the family aggregation rules, which treat the spouse, child, grandparent, or parent of a 5 percent owner as a 5 percent owner. Remember that family members may have different last names.[2]

Changes in Testing Method

Change from current year testing method to prior year testing method. A plan that elects to continue using the current year testing method may be subject to certain restrictions should an employer wish to change to the prior year testing method: one governs the revocability of the election, and a second limits the "double counting" of certain contributions.

The election to use the current year testing method ordinarily will not be revocable except with the permission of the IRS.[3] Regulations provide for limited circumstances under which a plan will be permitted to change from the current year testing method to the prior year testing method.[4] A plan that changes from the current year testing method to the prior year testing method also is subject to limitations designed to prevent double counting of certain contributions.[5] Plans using the prior year testing method may change back to the current year method for any subsequent testing year.[6]

Special rules apply in the first plan year; essentially a plan other than a successor plan may designate the ACP of nonhighly compensated employees at 3 percent in the first plan year that the plan uses the prior year testing method. The employer may elect to use the plan's first year ACP results instead.[7] The plan document must specify the method that will be used.[8]

Use of QNECs to Satisfy ACP Test

Elective and qualified nonelective contributions ("QNECs") may be taken into account in determining whether a plan satisfies the ACP test, provided certain requirements are met.[9] A "QNEC" is any employer contribution (other than elective contributions and matching contributions) with respect to which the employee does not have an election to receive the amount in cash and that satisfies the nonforfeitability and withdrawal restrictions applicable to elective deferrals to qualified cash or deferred (401(k)) arrangements (Q 3698 and Q 3729).[10]

Employer matching contributions that are treated as elective contributions for purposes of the actual deferral percentage ("ADP") test applicable to cash or deferred arrangements (Q 3731)

1. Treas. Reg. §1.401(m)-2(c)(3).
2. See 401(k) Plan Fix-It Guide, at http://www.irs.gov/Retirement-Plans/401(k)-Plan-Fix-It-Guide-The-plan-failed-the-401(k)-ADP-and-ACP-nondiscrimination-tests.
3. IRC Sec. 401(m)(2)(A).
4. Treas. Reg. §1.401(m)-2(c)(1), 1.401(k)-2(c)(1)(ii).
5. Treas. Reg. §1.401(m)-2(a)(6)(vi).
6. IRC Sec. 401(m)(2)(A). See Treas. Reg. §1.401(m)-2(c)(1).
7. Treas. Reg. §1.401(m)-2(c)(2)(i).
8. Treas. Reg. §1.401(m)-1(c)(2).
9. See Treas. Reg. §1.401(m)-2(a)(6).
10. IRC Sec. 401(m)(4); Treas. Regs. §§1.401(m)-5, 1.401(k)-1(c)-(d).

are not subject to the ACP test above and may not be used to help employee contributions or other matching contributions to satisfy this test. Similarly, a QNEC that is treated as an elective contribution is subject to the ADP test and is not taken into account as a matching contribution for purposes of the ACP test.[1]

Under limited circumstances set forth in regulations, an employer may elect to include certain elective contributions and QNECs in computing the contribution percentage.[2] To be taken into account in the calculation of the ACP for a year under the prior year testing method, a QNEC must be contributed no later than the end of the twelve month period following the applicable year, even though that year is different than the plan year being tested.[3]

Calculation of Actual Contribution Percentage

The ACP for a group of eligible employees is the average of their actual contribution ratios ("ACRs") for the year, computed separately for each employee and to the nearest one-hundredth of one percent. An employee's ACR is (1) the sum of matching contributions and employee contributions (including any QNECs taken into account) divided by (2) the employee's compensation (Q 3801).[4] Special rules apply for the first year a plan, other than a successor plan, is in existence.[5]

Compensation for this purpose generally is the same as under IRC Section 414(s) (Q 3783), based on the plan year or the calendar year ending within the plan year; the period selected must be applied uniformly for every eligible employee under the plan.[6]

A matching contribution is (1) any employer contribution, including a discretionary contribution, to a defined contribution plan on account of an employee contribution to a plan maintained by the employer, (2) any employer contribution, including a discretionary contribution, to a defined contribution plan on account of an elective deferral (Q 3705),[7] and (3) any forfeiture allocated on the basis of employee contributions, matching contributions, or elective contributions.[8]

For purposes of the ACP test, employee contributions generally are contributions that are designated or treated at the time of contribution as after-tax employee contributions, and are allocated to an individual account for each eligible employee.[9]

Matching contributions are taken into account for a plan year only if such contributions are (1) allocated to the employee's account under the terms of the plan as of a date within the plan year, (2) made on behalf of an employee on account of the employee's contributions (elective

1. Treas. Reg. §1.401(m)-2(a)(6)(vi).
2. IRC Sec. 401(m)(3); Treas. Reg. §1.401(m)-2(a)(6).
3. Treas. Reg. §1.401(m)-2(a)(6)(i).
4. Treas. Reg. §1.401(m)-2(a)(3)(i).
5. IRC Secs. 401(m)(3), 401(k)(3)(E).
6. Treas. Reg. §1.401(m)-5.
7. As defined in Treas. Reg. §1.402(g)-1(b).
8. IRC Sec. 401(m)(4)(A); Treas. Reg. §1.401(m)-1(a)(2).
9. See Treas. Reg. §1.401(m)-1(a)(3) for details.

or otherwise) for the plan year, and (3) actually paid to the trust no later than the end of the twelve month period immediately following the close of the plan year.[1]

Matching contributions that do not satisfy these requirements may not be considered in applying the ACP test for any plan year, but instead must meet the general test for the nondiscriminatory amount requirement (Q 3764) by treating them as if they were nonelective contributions and were the only nonelective employer contributions for the year.[2]

An eligible employee generally is any employee who is directly or indirectly eligible to make a contribution or to receive a matching contribution (including those derived from forfeitures) for all or a portion of the plan year. Employees who would be eligible to make contributions were it not for a suspension or an election not to participate also are considered eligible.[3]

Under a special rule for early participation, a plan that separately satisfies the minimum coverage rules (Q 3762), taking into account only those employees who have not completed one year of service or are under age twenty-one, may ignore, for purposes of the ACP test, eligible nonhighly compensated employees who have not met the age and service requirements in applying the ACP test.[4] This provision is designed to encourage employers to include younger employees in the plan without the concern that they will "pull down" the ACP test results.

Although a plan must, by its terms, provide that the ACP test will be met, it may incorporate by reference the IRC Section 401(m) nondiscrimination provisions.[5]

Miscellaneous Rules

Plans that accept rollover contributions generally assume the risk that the contributions qualify for rollover treatment (Q 3880). The IRS has determined that where a plan accepted a rollover contribution that, in fact, did not qualify for rollover, the amount involved was received by the plan as a voluntary employee contribution, which had to be considered for purposes of the ACP test explained above.[6]

Matching contributions, other than QMACs (Q 3731), on behalf of self-employed individuals are not treated as an elective employer contribution for purposes of the limit on elective deferrals under IRC Section 402(g).[7]

3733. What happens if a 401(k) plan fails its nondiscrimination testing?

A plan's continued tax qualification is conditioned on its meeting the operational requirements of IRC Section 401(c). For a 401(k) plan, that includes passage of annual ADP and ACP

1. Treas. Reg. §1.401(m)-2(a)(4)(iii).
2. Treas. Reg. §1.401(m)-2(a)(5).
3. See IRC Sec. 401(m)(5); Treas. Reg. §1.401(m)-5.
4. IRC Sec. 401(m)(5)(C); Treas. Reg. §1.401(m)-3(j)(3).
5. Treas. Reg. §1.401(m)-1(c)(2).
6. See Let. Rul. 8044030.
7. IRC Sec. 402(g)(8).

testing. When that testing fails, a plan is required either to make certain additional contributions for the non-highly compensated employees or certain distributions to the highly compensated employees.[1] Thus, a failure to make these corrections for a failed test is an operational failure that could lead to a loss of the plan's tax qualification.

When a 401(k) plan fails the ADP testing and elects to distribute certain deferrals to highly compensated employees, those deferrals are referred to as excess contributions.

When a plan's matching contributions fail the ACP testing and the plan elects to distribute certain matching contributions to highly compensated employees, those matching contributions are referred to as excess aggregate contributions. The complexity of the ADP and ACP tests, as well as that of the rules that follow, have led many employers to implement design-based plans that are deemed to satisfy these tests (Q 3710, Q 3715).[2]

Excess Contributions

An otherwise qualified 401(k) plan with a failed ADP test will not be disqualified if, before the end of the following plan year, any excess contributions are distributed along with any allocable income. Additional contributions ("QNECs") may be made to the plan by the employer to the accounts of the non-highly compensated employees sufficient to pass ADP testing.[3] Another seldom-used option permits recharacterization of these deferrals by treating them as if they had been distributed to the employee and then contributed by the employee to the plan on an after-tax basis. These after-tax employee contributions then are included in the ACP testing. Excess contributions may not remain unallocated in the plan or held in a suspense account for allocation in future years.[4]

Excess contributions are to be distributed (or otherwise corrected) within 2½ months after the end of the plan year to avoid the employer being subject to a 10 percent excise tax on the amount distributed.[5] A plan that contains an automatic enrollment (even if not an "eligible automatic contribution arrangement") is subject to an extended time period for distributing refunds of excess contributions of six months rather than 2½ months.[6]

An excess contribution may consist of elective salary deferrals, Roth employee contributions, QNECs and QMACs, and certain employer contributions, all of which are included in ADP testing.[7] A plan will specify whether an ordering of the distributions is required (Q 3685). Salary deferrals and Roth contributions that exceed $17,500 in 2013 and 2014 ($17,000 in 2012) are referred to as "excess deferrals" (Q 3705) and should not be confused with excess contributions. Special rules apply for coordinating distributions of excess contributions and excess deferrals.[8]

1. See Rev. Proc. 2013-12 Appendices A (section 3) and B (section 2).
2. See Treas. Regs. §§1.401(k)-1(g), 1.401(m)-1(d).
3. Treas. Regs. §54.4979-1(c)(4); Rev. Proc. 2013-12 Appendices A (section 3).
4. IRC Sec. 401(k)(8); Treas. Reg. §1.401(k)-2(b)(1).
5. IRC Sec. 4979; Treas. Regs. §§1.401(k)-2(b)(5), 54.4979-1.
6. Treas. Regs. §1.401(k)-2(b)(5)(iii).
7. IRC Sec. 401(k)(8)(B). See Treas. Regs. §§1.401(k)-6, 1.401(k)-2(b)(2)(iii).
8. See Treas. Reg. §1.401(k)-2(b)(4)(i).

Excess contributions and income thereon distributed to an employee are treated as earned and received by the employee in the year in which the distributions are made.[1]

Where the plan specifies, or where the employer elects to make corrective distributions of excess contributions and the distribution is not made within 2½ months after the close of the plan year (or six months if the plan has an automatic enrollment feature), two requirements are triggered. The employer pays a penalty of 10 percent of the excess distribution,[2] and a statutory twelve month period applies. If the distribution occurs more than twelve months after the close of the plan year, the plan has an operational failure that must be corrected under EPCRS to avoid the plan's disqualification.[3]

Corrective distributions of excess contributions may be made without regard to the spousal consent rules (Q 3792).[4] Corrective distributions may not be considered for purposes of satisfying the minimum distribution requirements (Q 3801 to Q 3813).[5]

QNEC Contribution

A plan may provide for an employer to make fully vested contributions for certain non-highly compensated employees. These contributions then are included as deferrals in the ADP testing and, if sufficiently significant, can cause the plan to satisfy the ADP testing.

Recharacterization. Excess contributions of highly compensated employees may be recharacterized as after-tax employee contributions only to the extent that the recharacterized amount, together with the amount of any actual after-tax contributions, satisfies the ACP testing.[6] This amount is treated the same as a match in that testing.[7]

Recharacterized excess contributions must be included in an employee's gross income on the earliest date any elective contributions made on behalf of the employee during the plan year would have been received. The payor or plan administrator must report such amounts as employee contributions to the IRS and the employee.[8] These recharacterized contributions continue to be treated as employer contributions that are elective contributions for all other purposes under the IRC (for example, they remain subject to the nonforfeitability and withdrawal requirements applicable to elective contributions).[9]

Excess Aggregate Contributions

Excess aggregate contributions are the excess of the aggregate amount of employee contributions and employer matching contributions (including any QNECs or elective deferrals treated as matching contributions) made on behalf of highly compensated employees over the

1. IRC Sec. 4979(f)(2).
2. Treas. Reg. §§1.401(k)-2(b)(5), 54.4979-1(a)(4).
3. Treas. Reg. §1.401(k)-2(b)(5).
4. Treas. Reg. §1.401(k)-2(b)(2)(vii)(A).
5. Treas. Reg. §1.401(k)-2(b)(2)(vii)(C).
6. Treas. Reg. §1.401(k)-2(b)(3)(i).
7. Treas. Reg. §1.401(k)-2(b)(3)(ii).
8. See Treas. Reg. §1.401(k)-2(b)(3)(ii).
9. See Treas. Reg. §1.401(k)-2(b)(3)(iii)(C).

maximum amount permitted under the ACP test (Q 3732).[1] Distributions or forfeitures of excess aggregate contributions must be made to highly compensated employees under a process identified in regulations.[2]

A plan will not be disqualified for a failed ACP test for any plan year if, within the twelve month period following the close of that plan year, the excess aggregate contributions (including any income thereon) are distributed (or forfeited) by the plan.[3]

Any corrective distribution of less than the entire amount of the excess aggregate contributions is treated as a pro rata distribution of excess aggregate contributions and income.[4] No early (premature) distribution penalty tax is imposed on the distribution.[5] Corrective distributions may be made without regard to the spousal consent rules (Q 3792).[6] Furthermore, corrective distributions may not be considered for purposes of satisfying the required minimum distribution rules (Q 3801 to Q 3813).[7]

If the total amount of excess aggregate contributions (and income) is not distributed within the twelve month period following the close of the plan year, the plan will be treated as having an operational failure and will need to be corrected under EPCRS to retain its tax qualification.[8]

A penalty will be imposed on the employer unless the excess is distributed within 2½ months after the end of the plan year. The employer will be subject to a 10 percent excise tax.[9] For plan years beginning after 2007, a plan that satisfies the definition of any automatic contribution feature (Q 3707) is permitted an extended time period for distributing refunds of excess contributions. The extension for making the correction is from 2½ months to six months.[10]

Distributions of excess aggregate contributions (and income) are treated as received by the recipient in the taxable year of the employee ending with or within the plan year for which the original contribution was made. If the total excess amount, including any excess contributions to a 401(k) plan as discussed above, that is distributed to the recipient under the plan for the plan year is less than $100, it is includable in the taxable year distributed.[11] Amounts distributed more than 2½ months after the plan year are includable in gross income for the taxable year of the employee in which distributed.[12]

1. IRC Sec. 401(m)(6)(B); Treas. Reg. §1.401(m)-5.
2. IRC Sec. 401(m)(6)(C). For an example of this allocation, see Treas. Reg. §1.401(m)-2(b)(3)(ii). See also Revenue Procedure 2013-12, Appendix B.
3. IRC Sec. 401(m)(6); Treas. Reg. §1.401(m)-2(b)(1).
4. Treas. Reg. §1.401(m)-2(b)(3)(iv).
5. Treas. Reg. §1.401(m)-2(b)(2)(vi).
6. Treas. Reg. §1.401(m)-2(b)(3)(i).
7. Treas. Reg. §1.401(m)-2(b)(3)(iii).
8. Treas. Reg. §1.401(m)-2(b)(4)(ii).
9. IRC Sec. 4979; Treas. Reg. §1.401(m)-2(b)(4)(i).
10. IRC Secs. 401(k)(13), 401(m)(12), 414(w), Treas. Reg. §1.401(m)-2(b)(4)(iii).
11. Treas. Reg. §1.401(m)-2(b)(2)(vi)(B).
12. Treas. Reg. §1.401(m)-2(b)(2)(vi)(A).

Instead of distributing excess aggregate contributions, an employer may, to the extent permitted by the terms of the plan, correct the excess by making additional QNECs that, when combined (Q 3732) with employee contributions and matching contributions, satisfy the ACP test. Excess aggregate contributions may not be corrected by forfeiting vested matching contributions, by recharacterization, by failing to make matching contributions required under the plan, by refusing to allocate the excess aggregate contributions, or by holding contributions in a suspense account for allocation in future years.[1]

In the case of a plan that includes a cash or deferred arrangement, the determination of excess aggregate contributions is made after determining excess deferrals (Q 3705) and excess contributions to the cash or deferred arrangement (Q 3731).[2]

Fully Insured Plans (412(i))

3734. What is a fully insured, or 412(i) plan?

A "fully insured" defined benefit pension plan was originally subject to IRC Section 412(i). These are defined benefit plans that are entirely funded by life insurance and annuity contracts. After the passage of the Pension Protection Act of 2006, the term 412(i) became a misnomer because that legislation restructured the IRC and these plans are now governed by IRC Sections 404(o) and 412(e)(3). No substantive changes were made to the law.[3]

These plans have found favor in the advisor community because they offer the ability to deduct contributions similar to other defined benefit pension plans but are not subject to the funding that requires certification by an actuary each year with the filing of a Schedule B. This exemption requires that the status and operation of the plan follow very strict rules; if violated, these rules require the plan to operate as a traditional defined benefit pension plan including the filing of Schedule B. When a Schedule B is required to be filed and is not for an ERISA qualified plan, the Form 5500 that was filed becomes delinquent, triggering a possible $1,000 a day fine.[4]

A fully insured plan is also subject to all of the qualification requirements that apply to any other defined benefit plan, although it should be noted that the funding arrangement is not a qualification requirement. The general qualification requirements are explained at Q 3758 to Q 3832 and plan-specific qualification requirements are explained at Q 3666 to Q 3667, Q 3681 and Q 3684.

The IRS has issued extensive guidance designed to target three potentially abusive issues: (1) the valuation of life contracts held by and distributed out of such plans, (2) discrimination in the types of contracts provided to highly compensated employees, versus the rank and file, and (3) the ability of employers to purchase and deduct premiums paid for amounts of life insurance

1. Treas. Reg. §1.401(m)-2(b)(1)(iii).
2. IRC Sec. 401(m)(6)(D).
3. See Pub. L. 109-280, Sec. 111.
4. 29 U.S.C. §1132(c)(2).

the IRS views as excessive. For details on the application of these standards in the fully insured (Section 412(i)) plan context, see Q 3735.[1]

Planning Point: Certain abusive 412(i) plans are treated as a listed transaction that, if not properly reported on the employer's (and employee's) tax filing, can result in violation with flat penalties of $100,000 to $200,000 for each non filing.[2] The IRC currently provides for no relief on this penalty. Thus, any individual with a 412(i) plan should confirm annually with the provider of the plan whether the plan is operating as a plan that is treated as a listed transaction.

3735. What requirements must a fully insured plan (a "412(i) plan") meet to be exempt from the minimum funding requirements?

A fully insured plan, known as a "Section 412(i) plan" and governed by IRC Section 412(e)(3), is a defined benefit plan that is funded entirely by a combination of life insurance and annuity contracts. This plan can avoid the funding requirements and certain reporting requirements of other defined benefit plans or plans when certain requirements are met initially and annually:

(1) The plan must be funded exclusively with individual insurance or annuity contracts (or a combination of both);

(2) The contracts must provide for payment of level annual or more frequent premiums over a period ending no later than the normal retirement age of each participant, or the date when the participant ceases participation in the plan, if earlier, and beginning on the date (or the first payment date occurring thereafter) when the individual became a participant, or the time an increase in benefits became effective;

(3) The benefits provided each individual under the terms of the plan must equal the benefits provided under each contract at normal retirement age and must be guaranteed by an insurance carrier to the extent premiums have been paid;

(4) All premiums must have been paid before the policy due date. In the case of a lapse of policy for late payment, the reinstatement of the policy must occur during the plan year of the lapse and before benefits commence to any participant whose benefits are impacted by the lapse;

(5) No rights under the contract may have been subject to a security interest at any time during the plan year; and

(6) There are no policy loans on the insurance (including loans to individual participants) at any time.[3]

1. See TD 9223, 70 Fed. Reg. 50967 (Aug. 29, 2005); Rev. Proc. 2005-25, 2005-17 IRB 962; Rev. Rul. 2004-20, 2004-10 IRB 546; Rev. Rul. 2004-21, 2004-10 IRB 544.
2. IRC Sec. 6707A(b)(2)(A).
3. IRC Sec. 412(e)(3).

A plan funded exclusively with group contracts, which has the same characteristics as described above, also will be exempt.[1] A plan may be funded by a combination of individual contracts and a group contract, if the combination, in the aggregate, satisfies the requirements.[2]

Regulations finalized in 2005 require that life insurance contracts distributed from any qualified plan be valued at their fair market value (Q 538).[3] Abuse in this area has been subject to a rigorous audit program by the IRS.

As any other qualified plan, a fully insured plan is subject to IRC requirements prohibiting discrimination against nonhighly compensated employees. This requirement applies to contributions and benefits (Q 3764), as well as the availability of any other benefits, rights and features (Q 3776). Plans providing uniform benefits and meeting the safe harbor requirements will satisfy the "nondiscriminatory in amount" requirement of IRC Section 401(a)(4) (Q 3764).[4] The IRS has stated that a plan that provides highly compensated employees the right to purchase life insurance contracts from the plan at cash surrender value, but does not provide that right (or rights of equal value) to nonhighly compensated employees, violates the nondiscrimination requirement.[5]

The IRS also has ruled that differences in cash value growth terms or different exchange features among life insurance contracts can create an optional form of benefit, or distinctly different rights and features (Q 3776), even if the terms under which the contracts can be purchased from the plan are the same. The IRS noted that one benefit right or feature is of inherently equal or greater value than another benefit, right, or feature (i.e., it is nondiscriminatory) only if, at any time and under any conditions, it is impossible for any employee to receive a smaller amount or a less valuable right under the first benefit, right, or feature than under the second benefit, right, or feature. If this "inherently equal to or greater than" standard is not met, when comparing the benefits, rights and features available to nonhighly versus highly compensated employees, the plan is discriminatory.[6]

Miscellaneous Rules

Premium payments will be considered level even though experience gains and dividends are applied against premiums.[7] The requirement that a plan be funded exclusively by insurance contracts does not prevent an employer from making payments to satisfy minimum vesting requirements with respect to accrued benefits derived from employee contributions. For example, an employer may pay the "load factor" on insurance contracts to meet requirements that an employee be 100 percent vested in the accrued benefit derived from his or her own

1. IRC Sec. 412(e)(3); Treas. Reg. §1.412(i)-1(c).
2. Treas. Reg. §1.412(i)-1(d).
3. 2005-2 C.B. 591, T.D. 9223.
4. Treas. Reg. §1.401(a)(4)-3(b)(5).
5. See Rev. Rul. 2004-21, 2004-10 IRB 544.
6. Rev. Rul. 2004-21, 2004-10 IRB 544.
7. Treas. Reg. §1.412(i)-1(b)(2)(ii).

contributions.[1] Furthermore, if certain conditions are met, a side fund may be used to fund the additional benefits required when a plan is top-heavy (Q 3818, Q 3823).[2]

3736. Are there any limits on the amount of life insurance that a fully insured (412(i)) plan can purchase to fund the plan?

A 412(i) plan must limit the amount of life insurance that can be provided under the plan. A failure to meet this requirement is a qualification failure that could lead to a disqualification; it also may result in the plan becoming a listed transaction.

The IRS has provided guidance illustrating two circumstances under which fully insured (Section 412(i)) plans have purchased excessive amounts of life insurance.[3] In the first example, the participant's benefit payable at normal retirement age was not equal to the amount provided at normal retirement age with respect to the contracts held on behalf of that participant. The IRS ruled that such a plan fails to satisfy the requirements of IRC Section 412(e)(3)(C), as redesignated by PPA 2006. Accordingly, although the plan still can be a qualified defined benefit plan, it must satisfy the other requirements of IRC Section 412, including reasonableness of actuarial assumptions.

In the second example, the life insurance contracts on the life of a participant provided for death benefits in excess of the death benefit provided to that participant under the plan. In the example, on the employee's death, proceeds in excess of the death benefit payable to the employee's beneficiary were applied to the payment of premiums with respect to other participants.

The IRS ruled that the portion of contributions attributable to excess coverage did not constitute "normal cost" and thus, was not deductible. Similarly, contributions to pay premiums for the disability waiver of premium feature with respect to such excess coverage were not deductible. Instead, such amounts are carried over to later years.

With respect to the excess coverage, the IRS stated that such premiums could be carried over and treated as contributions in later years. They are deductible in years when excess death benefits are used to satisfy the employer's obligation to pay future premiums on other participants. It should be noted that nondeductible contributions are subject to a 10 percent excise tax under IRC Section 4972 (Q 3840).

Transactions that are substantially similar to the example in which excessive death benefit coverage is held are classified as "listed transactions" if the employer has deducted amounts used to pay premiums on a life insurance contract with a death benefit exceeding the participant's death benefit under the plan by more than $100,000.[4]

1. Treas. Regs. §§1.412(i)-1(b)(2)(i), 1.412(i)-1(c)(2)(i).
2. See Treas. Reg. §1.416-1, M-17.
3. See Rev. Rul. 2004-20, 2004-10 IRB 546.
4. See Rev. Rul. 2004-20, 2004-10 IRB 546; *Zarrella v. Pac. Life Ins. Co.*, 820 F. Supp. 2d 1371 (S.D. Fla. 2011), *aff'd*, 498 Fed. Appx. 945 (11th Cir. 2012).

3737. Can an existing defined benefit plan be converted into a fully insured (412(i)) plan?

An existing defined benefit plan can be converted to a fully insured plan, and the requirement that payment of level annual premiums commence with the beginning of plan participation will be considered satisfied, if:

(1) the plan otherwise satisfies the requirements under IRC Sections 412(e)(3), 403(a), and 404(a)(2) for the plan year containing the conversion date;

(2) all benefits accruing for each participant on and after the conversion date are funded by level annual premium contracts under which payments begin at the time when the increased accrual becomes effective and end not later than the individual's normal retirement age;

(3) all benefits accrued for each participant prior to the conversion date are guaranteed through insurance or annuity contracts, the purchase price of which equals the minimum amount required by the life insurance company for a contract that guarantees to provide the accrued benefits, including any optional forms of benefit;

(4) there are meaningful continuing benefit accruals under the plan after the conversion date (i.e., for at least three years); and

(5) the following are accomplished before the conversion date: (x) the contracts are purchased guaranteeing the benefits, (y) any remaining plan assets are applied to the payment or prepayment of premiums described in (2) above, and (z) any necessary plan amendments are adopted and made effective.[1]

The IRS determined that where a defined benefit plan was terminated and plan assets were used to purchase fully insured annuity contracts for participants, no "meaningful benefit accruals" would occur after the date of the conversion; thus, the plan could not meet the requirements for conversion.[2]

Final nondiscrimination regulations under IRC Section 401(a)(4) include a safe harbor for fully insured insurance contract plans.[3]

Stock Bonus and Employee Stock Ownership Plans

3738. What is a stock bonus plan?

A stock bonus plan is a profit sharing plan that holds employer securities and generally distributes those securities to participants when benefits are paid.[4] These plans can be funded through contribution of employer securities, cash, or both. Traditionally, the IRS has taken the

1. Rev. Rul. 94-75, 1994-2 CB 59.
2. TAM 9234004.
3. Treas. Reg. §1.401(a)(4)-3(b)(5).
4. Treas. Reg. §1.401-1(a)(2)(iii).

position that the distribution must be in the form of employer stock (except for the value of a fractional share).[1] The Tax Court has upheld this requirement.[2] A stock bonus plan may provide for payment of benefits in cash if certain conditions are met (Q 3741). For the purpose of allocating contributions and distributing benefits, the plan is subject to the same requirements as a profit sharing plan.

3739. What is an employee stock ownership plan ("ESOP")?

An employee stock ownership plan ("ESOP") is a defined contribution plan and can be either a qualified stock bonus plan or a profit sharing or money purchase pension plan, or any combination.[3] The unique feature of this type of plan is that an ESOP is permitted to purchase employer securities through a loan. A similar purchase under any other plan would be a prohibited transaction.[4] The loan can be from the employer or another party, such as a bank. Although an ESOP is designed to invest primarily in employer securities, the trustee of the ESOP must make a determination as to whether the purchase of employer securities for the plan is prudent. In *Fifth Third Bancorp v. Dudenhoeffer*,[5] the Supreme Court rejected that a trustee is not entitled to a presumption of prudence.

The IRC specifies that an ESOP must be designed to invest primarily in "qualifying employer securities."[6] Qualifying employer securities are shares of common stock issued by the employer (or a member of the same controlled group) (1) readily tradable on an established securities market or, in case there is no such readily tradable stock, (2) having a combination of voting power and dividend rights at least equal to the class of common stock having the greatest voting power and the class of common stock having the greatest dividend rights.

Non-callable preferred shares also qualify, if they are convertible into stock meeting the requirements of (1) or (2) (as appropriate) and if the conversion price is reasonable at the time the shares are acquired by the plan.[7] The IRS determined that the common stock of a corporation did not constitute employer securities with respect to employees of a partnership owned by the corporation's subsidiary because a partnership is not a corporate entity. As a result, the employees of the partnership could not participate in the corporation's ESOP.[8]

Certain tax-exempt entities (such as a qualified retirement plan trust) are eligible to be shareholders of S corporations; consequently, S corporations may adopt ESOPs.[9] Rigorous restrictions apply when the employer is an S corporation (Q 3679, Q 3746, Q 3747).

An ESOP is an "eligible individual account plan" (Q 3740) that meets additional, stricter requirements. The significant tax advantages of meeting the stricter requirements for an

1. Rev. Rul. 71-256, 1971-1 CB 118.
2. *Miller v. Comm.*, 76 TC 433 (1981).
3. IRC Sec. 4975(e)(7).
4. IRC Sec. 4975(d)(3).
5. 134 S. Ct. 2459 (2014).
6. IRC Sec. 4975(e)(7).
7. IRC Secs. 4975(e)(8), 409(l).
8. GCM 39880 (10-8-92).
9. See IRC Sec. 1361(c)(6); Senate Committee Report for SBJPA '96.

ESOP are that certain loan transactions, including a loan guarantee, between the plan and the employer are exempt from the prohibited transaction rules against loans between plans and parties-in-interest,[1] certain forfeitures and contributions are excluded from the annual additions limit (Q 3784, Q 3677), and increased deductions by a C corporation employer are permitted on loan repayments (Q 3746).

For loans made prior to August 21, 1996, certain lenders were permitted to exclude from income 50 percent of the interest received on certain loans to an ESOP or sponsoring corporation used to purchase employer securities.[2] This exclusion was repealed, but certain refinancings and loans pursuant to a written contract in effect on June 10, 1996, are treated as having been made prior to the effective date of the repeal.[3]

3740. May plans other than stock bonus and employee stock ownership plans hold investments in employer securities?

Yes, but under limited circumstances and normally only under a profit sharing plan.

If, immediately after the acquisition, the aggregate fair market value of the employer securities and of employer real property held by the plan exceeds 10 percent of the fair market value of the plan's assets, then only an "eligible individual account plan" that explicitly provides for the acquisition and holding of "qualifying employer securities" may acquire the employer securities.[4]

An eligible individual account plan is an individual account plan that is a profit sharing, stock bonus, thrift, or savings plan, or an employee stock ownership plan (Q 3739). A money purchase plan (a defined contribution pension plan) that was in existence on September 2, 1974, and that on that date invested primarily in qualifying employer securities, has certain grandfathered rights as to employer securities. Qualifying employer securities are employer's stock and certain marketable obligations.[5]

S corporation stock generally may be held by an exempt plan or a tax-exempt organization; thus, S corporations may establish a plan designed to invest primarily in employer securities, including an ESOP (Q 3739, Q 3741, Q 3747).[6] These plans also may be installed by other small closely held corporations, as well as by corporations with shares that are publicly traded. The transfer of stock to such a plan by the employer is exempt from the prohibited transaction restrictions if the transfer is for an adequate value and no commission is charged.[7]

An investment in employer securities must satisfy ERISA's fiduciary standards, which require that an investment in employer stock be prudent. An individual account plan (whether profit sharing, stock bonus, thrift, or savings, and whether qualified or not) designed to invest in more

1. IRC Sec. 4975(d)(3); ERISA Sec. 408(b)(3).
2. IRC Sec. 133, prior to repeal by SBJPA '96.
3. SBJPA '96, Sec. 1602(c).
4. ERISA Secs. 407(a)(2), 407(b).
5. ERISA Secs. 407(a)(2), 407(b)(1), 407(d)(5).
6. IRC Sec. 1361(b)(1)(B).
7. IRC Sec. 4975(d)(3).

than 10 percent of qualifying employer securities is exempt from the requirement that a plan trustee diversify the trust's investments.[1]

Investments in employer securities by qualified plans must satisfy IRS requirements that the plan be for the exclusive benefit of employees or their beneficiaries.[2] The Conference Committee Report on ERISA indicates that to the extent a fiduciary meets the prudent investment rules of ERISA, it will be deemed to meet the exclusive benefit requirements of Revenue Ruling 69-494.[3]

To qualify, a plan must meet the applicable requirements set forth in Q 3675, Q 3696, and Q 3758. Notice that Q 3675 explains that profit sharing plans are not required to pass through voting rights. If a plan is not qualified, it is subject to the rules in Q 3523 to Q 3531.

3741. What special qualification requirements apply to stock bonus plans and employee stock ownership plans?

In addition to meeting all of the requirements of IRC Section 401(a), stock bonus plans and employee stock ownership plans ("ESOPs") (Q 3742) must meet certain additional requirements as to employer stock that is held by the plan. There are requirements concerning distribution of employer securities, diversification, and certain pass-through voting requirements.[4]

Furthermore, an ESOP that holds stock in an S corporation must provide that no "prohibited allocation" will take place with respect to any portion of the assets of the plan attributable to such securities.[5]

Where employer securities are not readily traded on a public market, any transactions involving stock require an independent valuation of the stock for that transaction.

A stock bonus plan or ESOP generally is required to give participants the right to demand benefits in the form of employer securities. If employer securities are not readily tradable on an established market, the participant must have the right to require the employer (not the plan) to repurchase employer securities under a fair valuation formula (a "put option").[6]

The requirement that participants have the right to demand benefits in the form of employer securities does not apply to the portion of a participant's ESOP account that has been reinvested under applicable diversification rules (Q 3680, Q 3742).[7] The requirement also does not apply in the case of an employer whose charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees, to a qualified plan trust, or to an S corporation (Q 3748).[8] Anti-cutback relief generally is available for ESOPs that are

1. ERISA Sec. 404(a)(2).
2. Rev. Rul. 69-494, 1969-2 CB 88.
3. 1969-2 CB 88.
4. IRC Secs. 401(a)(23), 4975(e)(7).
5. IRC Secs. 409(p), 4975(e)(7).
6. IRC Sec. 409(h).
7. IRC Sec. 409(h)(7).
8. IRC Sec. 409(h)(2)(B).

amended to eliminate the right of participants to demand benefits in the form of employer securities (Q 3786).[1]

The put option must be available for at least sixty days following distribution of the stock and, if not exercised within that time, for another sixty day period (at a minimum) in the following year.[2]

Planning Point: Regulations have not yet been issued governing when the second option period should begin. One realistic approach is for the second sixty day period to begin after the next plan year's appraisal has been obtained by the plan trustee. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

The plan may repurchase the stock instead of the employer, but the plan cannot be required to do so. Banks prohibited by law from redeeming or purchasing their own shares are excused from the requirement that they give participants a put option.[3]

If, pursuant to a put option, an employer is required to repurchase securities distributed to an employee as part of a "total distribution," the amount paid for the securities must be paid in substantially equal periodic payments (at least annually), over a period beginning within thirty days after the exercise of the put option, and not exceeding five years. Adequate security must be provided, and a reasonable interest paid on unpaid amounts. A total distribution is a distribution to the recipient within one taxable year of the balance to the credit in his or her account.[4] If an employer is required to repurchase securities distributed to an employee as part of an "installment distribution," the amount paid for the securities must be paid within thirty days after the put option is exercised.[5]

Distributions are subject to mandatory 20 percent withholding, unless the employee elects a direct rollover.[6] The mandatory withholding requirement does not apply to any distribution that consists only of securities of the employer corporation and cash of up to $200 in lieu of stock. The maximum amount to be withheld under the mandatory withholding rules may not exceed the sum of the amount of money received and the fair market value of property other than securities of the employer corporation received in the distribution.[7]

The plan must provide that if a participant with the consent of his or her spouse so elects, the distribution of the account balance will commence within one year after the plan year (1) in which the participant separates from service by reason of attainment of the normal retirement age under the plan, disability, or death, or (2) which is the fifth plan year following the plan year in which the participant otherwise separated from service. Distribution under (2) will not be required if the participant is re-employed by the employer before distributions actually begin

1. Treas. Reg. §1.411(d)-4, A-2(d)(2)(ii), A-11.
2. IRC Sec. 409(h)(4).
3. IRC Sec. 409(h)(3).
4. IRC Sec. 409(h)(5).
5. IRC Sec. 409(h)(6).
6. IRC Sec. 3405(c).
7. IRC Sec. 3405(e)(8).

under (2).[1] Special rules, explained below, apply to leveraged ESOPs where the loan or loans used to acquire the employer securities remain outstanding.[2]

The plan also must provide that, unless the participant elects otherwise, distribution of his or her account balance will be in substantially equal periodic payments (at least annually) over a period not longer than the greater of (1) five years, or (2) in the case of a participant with an account balance in excess of $1,050,000 as indexed for 2014 (up from $1,035,000 in 2013), five years plus one additional year (not to exceed five additional years) for each $210,000 in 2014 (up from $205,000 in 2013), or fraction thereof, by which the employee's account balance exceeds $1,050,000.[3]

If employer securities in an ESOP are acquired with the proceeds of a loan and repayments of principal are deductible under IRC Section 404(a)(9) (Q 3746), the securities are not considered to be part of a participant's account balance for purposes of these rules until the close of the plan year in which the loan is fully repaid.[4]

Planning Point: An employer whose stock is not publicly traded, and therefore is subject to the employer's potential obligation to repurchase its stock from terminating plan participants, should be concerned about the impact that obligation could have on its cash flow. The employer should consider writing its plan to take the maximum time allowed, generally five years, to begin the process of distributing stock from the plan and then repurchasing that stock from former employees. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

Notwithstanding these requirements, if the general rules for commencement of distributions from qualified plans (Q 3801) require distributions to begin at an earlier date, those general rules control.[5]

A stock bonus plan or ESOP must pass through certain voting rights to participants or beneficiaries. If an employer's securities are "registration-type," each participant or beneficiary generally must be entitled to direct the plan as to how securities allocated to him are to be voted.[6] "Registration-type" securities are securities that must be registered under Section 12 of the Securities and Exchange Act of 1934 or that would be required to be registered except for an exemption in that law.[7]

If securities are not "registration-type" and more than 10 percent of a plan's assets are invested in securities of the employer, each participant (or beneficiary) must be permitted to direct voting rights under securities allocated to his or her account with respect to approval of corporate mergers, consolidations, recapitalizations, reclassifications, liquidations, dissolutions, sales of substantially all of the business's assets, and similar transactions as provided in future regulations.[8]

1. IRC Sec. 409(o)(1)(A).
2. See IRC Sec. 409(o)(1)(B).
3. IRC Sec. 409(o)(1)(C); Notice 2012-67 (Dec. 10, 2012); IR_2013-86 (Oct. 31, 2013).
4. IRC Sec. 409(o)(1)(B).
5. See General Explanation of TRA '86, p. 840.
6. IRC Secs. 401(a)(28), 4975(e)(7), 409(e)(2).
7. Sec. 12(g)(2)(H).
8. IRC Sec. 409(e)(3).

A plan meets this requirement in the case of non-registration-type securities if each participant is given one vote with respect to an issue and the trustee votes the shares held by the plan in a proportion that takes this vote into account.[1] The IRS has ruled that an ESOP will not fail to comply in operation with these pass-through voting requirements merely because the trustee of the ESOP votes the shares of stock allocated to participants' accounts for which no voting directions are timely received, whether the securities are registration type or non-registration-type.[2]

3742. What special qualification requirements apply to employee stock ownership plans ("ESOPs")?

Stock bonus plans and employee stock ownership plans ("ESOPs") must meet the requirements set forth in Q 3741; S corporation ESOPs must meet the special requirements described in Q 3747. ESOPs also must meet the requirements discussed below.

Qualified Sales

Provisions of the plan must ensure that, in the case of certain "qualified sales" of employer securities by a participant or executor to the ESOP, no portion of the assets of the plan (or any other qualified plan of the employer) attributable to the securities purchased by the plan may accrue or be allocated for the benefit of any of the following persons:

(1) a taxpayer who has elected to have the gain on the sale and replacement of employer securities deferred under the qualified sales rules of IRC Section 1042 (Q 3679);

(2) any individual who is a member of the family (brothers, sisters, spouse, ancestors, lineal descendants) or is related under the other rules of IRC Section 267(b) to the taxpayer described in (1);

(3) any person not described in (1) or (2) who owns, or is considered as owning under the attribution rules of IRC Section 318(a), more than 25 percent (by number or value) of any class of outstanding stock of the employer or of any corporation which is a member of the same controlled group of corporations as is the employer (Q 3830). For purposes of determining whether this limitation applies, an individual is treated as owning any securities he owned during the one-year period ending on the date of the sale to the plan, or as of the date the securities are allocated to participants in the plan.[3]

No employer securities acquired by the plan in any transaction to which IRC Section 1042 applied can be allocated to such persons. Thus, an employee who sold his employer securities to an ESOP and elected nonrecognition under IRC Section 1042 could not receive allocations based on other employer securities acquired by the plan in a different IRC Section 1042 transaction.[4]

1. IRC Secs. 401(a)(22), 409(e)(3), 409(e)(5).
2. Rev. Rul. 95-57, 1995-2 CB 62.
3. IRC Secs. 409(n)(1)(B), 409(n)(3)(B).
4. Let. Rul. 9041071.

Nonallocation Period

After the later of the date which is ten years after the date of the sale of securities or the date of the plan allocation attributable to the final payment on indebtedness incurred in connection with the sale, a plan may permit accruals or allocations for individuals described in (1) or (2), above, but not individuals described in (3). This ten year period is referred to as the "nonallocation period."[1] This time period should not be confused with the "nonallocation year" (Q 3747).

A special rule provides that the prohibition does not have to be applied under (2) to a lineal descendant of the taxpayer if the aggregate amount allocated for the benefit of all lineal descendants of the taxpayer during the nonallocation period is not more than 5 percent of the employer securities (or amounts allocated in lieu thereof) held by the plan which are attributable to a qualified sale by a member of any of the descendants' families (brothers, sisters, spouse, ancestors, lineal descendants).[2]

If a plan fails to meet these requirements, not only is the plan likely to be disqualified, but a penalty tax equal to 50 percent of the amount of any prohibited accrual or allocation will generally be levied against the plan. Also, the amount of any prohibited accrual or allocation will be treated as if distributed to the individual involved and taxed as such.[3]

Regulations

An ESOP must meet requirements set forth in applicable regulations.[4] The regulations require that an exempt loan be primarily for the benefit of participants and their beneficiaries. The proceeds of an exempt loan may not be used to buy life insurance; otherwise, the general rules applicable to the purchase of life insurance by qualified plans apply (Q 3751). The plan or employer may have a right of first refusal if the stock is not publicly traded.

Stock that is acquired after September 30, 1976, with the proceeds of an exempt loan and that is not publicly traded or that is subject to a trading restriction must be subject to a put option exercisable only by a plan participant or by the participant's donees or successors. The option must permit a participant to "put" the security to the employer but must not bind the plan. Nonetheless, the plan may have the right to assume the employer's obligation when the put option is exercised. An ESOP may not otherwise obligate itself to a put option or to acquire securities from a particular security holder on the happening of an event such as the death of the holder (e.g., a buy-sell agreement). Regulations provide rules for the current distribution of income. ESOPs generally may not be integrated with Social Security.[5]

1. IRC Secs. 409(n)(1)(A), 409(n)(3)(C).
2. IRC Sec. 409(n)(3)(A).
3. IRC Secs. 409(n)(2), 4979A.
4. IRC Sec. 4975(e)(7); ERISA Sec. 407(d)(6).
5. Treas. Regs. §§54.4975-7, 54.4975-11.

3743. What requirements regarding diversification of investments apply to employee stock ownership plans ("ESOPs")?

An ESOP generally must provide for diversification of investments by permitting a plan participant (including one who has already separated from service with the employer) who has completed 10 years of participation in the plan and attained age 55 to elect to direct the investment (allowing at least three investment options) of a portion of his account balance. (This requirement does not apply to plans subject to the diversification requirement explained at Q 3680).[1]

Planning Point: The IRS has issued relief from the anti-cutback rules of Section 411(d)((6) for a plan sponsor who amends a non-exempt ESOP to eliminate a distribution option that had previously satisfied the diversification requirements of Section 401(a)(28)(B) if the amendment occurs no later than the last day of the first plan year beginning on or after January 1, 2013 or by the deadline for the plan to satisfy Section 401(a)(35), if later.[2]

Planning Point: An employer sponsoring an ESOP that does not otherwise offer directed investments complying with these diversification requirements may wish to design the ESOP to offer a distribution election in lieu of a diversification election, rather than make the administration of the plan needlessly complex. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC*.

In the case of an ESOP that had not existed for ten years, the IRS permitted a plan participant to count years of participation in a terminated predecessor ESOP to meet the ten years of participation requirement.[3]

The diversification election is made within ninety days after the close of each plan year in the six-plan-year period, which begins with the plan year in which the employee becomes eligible to make the election. Generally, at least 25 percent of the account balance attributable to employer securities acquired by or contributed to an ESOP must be subject to the election; but in the last year of the six-plan-year period the 25 percent is increased to 50 percent.[4]

The amount that must be subject to the election at the end of a given year is generally equal to (1) 25 percent (or 50 percent in the last year) of the total number of shares of employer securities acquired by or contributed to the plan that have ever been allocated to the participant's account on or before the most recent plan allocation date, minus (2) the number of shares previously diversified.[5] Employer securities may not be one of the three investment options.[6]

A plan may meet this diversification requirement by distributing the portion of an account for which an election is made.[7] The diversification requirement can also be satisfied by allowing a participant to transfer that portion of an account for which an election is made into a qualified

1. IRC Sec. 401(a)(28).
2. Notice 2013-17, 2013-20 I.R.B. 1082 (Apr. 18, 2013).
3. Let. Rul. 9213006.
4. IRC Sec. 401(a)(28)(B)(i).
5. Notice 88-56, 1988-1 C.B. 540, A-9.
6. See General Explanation of TRA '86, p. 838.
7. IRC Sec. 401(a)(28)(B)(ii); Notice 88-56, 1988-1 C.B. 540.

defined contribution plan which provides for employee directed investment and in which the required diversification options are available.[1]

Any form of diversification elected (i.e., the distribution, transfer, or implementation of an investment option) must be completed within ninety days after the close of the election period.[2] An election to diversify may be revoked or amended, or a new election made, at any time during the ninety day election period.[3]

3744. What valuation requirements apply for employer securities held in employee stock ownership plans ("ESOPs")?

With respect to plan activities, all valuations of employer securities that are not readily tradable on an established securities market must be made by an independent appraiser whose name is reported to the IRS.[4]

Planning Point: If the company hires an appraiser and decides the appraised value is too high, that information is discoverable in any subsequent legal dispute, such as with the IRS. But if the company's attorney hires the appraiser, the appraisal remains in the files of the law firm and is subject to attorney-work product privilege. This allows the attorney to seek a lower appraisal, without fear that the appraisal for the higher amount will be discoverable and will create support for a finding of undervaluation. *Lawrence Brody, J.D., LL.M, Bryan Cave LLP*.

3745. What is a Section 1042 election? What rules apply to qualified sales to an ESOP?

A taxpayer or executor who sells qualified securities to an employee stock ownership plan ("ESOP") (Q 3739) and purchases qualified replacement property may be able to elect to defer recognition of long-term capital gain on the sale.[5] This is referred to as a Section 1042 election. If the election is made, the taxpayer or estate recognizes gain on the sale only to the extent that the amount realized on the sale exceeds the cost of the securities purchased to replace the stock sold to the ESOP.[6]

The election must be made in a written "statement of election" and filed with the taxpayer's return for the year of sale, including extensions.[7] The statement of election must contain specific information set forth in the regulations.[8] The election cannot be made on an amended return, and, once made, is irrevocable.[9] In the absence of such an election, the Tax Court denied the deferral of gain to a taxpayer whose estate argued unsuccessfully that he had "substantially complied" with the election requirements.[10] Similarly, where a taxpayer failed, through his accountant's error, to make a timely election, the IRS strictly construed the statutory deadline.[11]

1. Notice 88-56, 1988-1 C.B. 540, A-13.
2. IRC Sec. 401(a)(28)(B)(i); Notice 88-56, 1988-1 C.B. 540, A-13.
3. See General Explanation of TRA '86, p. 835.
4. IRC Sec. 401(a)(28)(C). See General Explanation of TRA '86, p. 840.
5. See IRC Sec. 1042(a).
6. IRC Secs. 1042(a), 1042(b)(3).
7. IRC Sec. 1042(c)(6); Temp. Treas. Reg. §1.1042-1T, A-3(a).
8. See Temp. Treas. Reg. §1.1042-1T, A-3(b).
9. Temp. Treas. Reg. §1.1042-1T, A-3(a).
10. *Estate of J.W. Clause*, 122 TC 115 (2004).
11. See Let. Rul. 9438016.

A taxpayer must file a statement from the employer whose employees are covered by the ESOP consenting to the application of an excise tax[1] if the transferred securities are disposed of prematurely (see below) and a tax[2] on prohibited allocations of securities acquired in the sale.[3] Failure to substantially comply with the statement of election and statement of consent requirements has resulted in denial of nonrecognition treatment.[4]

The qualified replacement property must be purchased during the period that begins three months before the sale and ends twelve months after the sale.[5] If the replacement property has not yet been purchased when the statement of election is required, the taxpayer must file a notarized statement of purchase with his or her income tax return for the tax year following the year for which the election was made. The statement of purchase must contain specific information and must be notarized within 30 days of the purchase.[6]

Qualified securities, for purposes of a Section 1042 exchange, means stock (1) in a domestic C corporation (i.e., not an S corporation) that has no stock outstanding that is readily tradable on an established securities market, and (2) that was not (x) acquired from a qualified pension, profit sharing, or stock bonus plan, (y) acquired under an employer stock option plan or an employee stock purchase plan, or (z) transferred to the individual in connection with his or her performance of services to the corporation.[7] In addition, the taxpayer must have held the qualified securities for at least three years before the sale to the ESOP.[8] Nonrecognition does not apply to any gain on the sale of any qualified securities that is includable in the gross income of any C corporation.[9]

Qualified replacement property means securities issued by a domestic operating corporation that (1) did not have more than 25 percent of its gross receipts in certain passive investment income (including, generally, receipts from rents, royalties, dividends, interest, annuities, and sales and exchanges of stock or securities) for the taxable year preceding the tax year in which the security was purchased, and (2) is not the corporation or a member of its controlled group (Q 3830) that issued the qualified securities being replaced.[10]

If a taxpayer does not intend to reinvest the total amount required, under IRC Section 1042, to completely defer the gain on the sale in replacement securities, the installment method may be available for the gain that does not qualify for nonrecognition, provided that the sale otherwise qualifies as an installment sale. The amount of gain is the same proportion of the installment payment actually received in such year that the total gain to be recognized under IRC Section

1. Under IRC Sec. 4978.
2. Under IRC Sec. 4979A.
3. IRC Sec. 1042(b)(3).
4. Let. Rul. 9733001.
5. IRC Sec. 1042(c)(3).
6. See Temp. Treas. Reg. §1.1042-1T, A-3.
7. IRC Sec. 1042(c)(1).
8. IRC Sec. 1042(b)(4).
9. IRC Sec. 1042(c)(7).
10. IRC Sec. 1042(c)(4)(A).

1042 bears to the total amount realized. The gain is recognized in the taxable year in which the installment payment is made.[1]

A taxpayer's basis in his or her replacement securities is reduced by the amount of gain not recognized. If more than one item is purchased, the unrecognized gain is apportioned among them.[2] If a taxpayer dies while still holding replacement securities, the basis provisions of IRC Section 1014 prevail and the replacement securities receive a stepped-up basis.[3] The holding period of the replacement property includes the holding period of the securities sold.[4]

To qualify for nonrecognition, the sale must meet certain additional requirements. The ESOP generally must own, immediately after the sale, at least 30 percent of each class of outstanding stock of the corporation that issued the qualified securities, or the total value of outstanding employer securities.[5]

The IRS has determined that where a note acquired by a company's owners from an ESOP in exchange for stock was a cash equivalent for tax purposes, the stock in a separate corporation acquired in exchange for the note constituted qualified replacement property.[6]

If a taxpayer disposes of any qualified replacement property, he or she generally will recognize gain (if any) to the extent that it was not recognized when the replacement property was acquired.[7] If a taxpayer owns stock representing control of a corporation that issued the replacement property, he or she will be treated as having disposed of his or her qualified replacement property if that corporation disposes of a substantial portion of its assets other than in the ordinary course of its trade or business.

The recapture rules do not apply if the transfer of the qualified replacement property is:

(1) in a reorganization (if certain requirements are met),

(2) by reason of the death of the person making the original election,

(3) by gift (even if a charitable deduction is obtained)[8], or

(4) in a subsequent transfer that is eligible for an election not to recognize gain under the rules discussed above.[9]

1. Let. Ruls. 9102021, 9102017.
2. IRC Sec. 1042(d).
3. Let. Rul. 9109024.
4. IRC Sec. 1223(13).
5. IRC Sec. 1042(b)(2).
6. Let. Rul. 9321067.
7. IRC Sec. 1042(e).
8. See TAM 9515002.
9. IRC Sec. 1042(e)(3).

A transfer to a revocable trust by a taxpayer will not trigger recapture where the grantor (i.e., the taxpayer) will continue to be treated as the owner of the property transferred to the grantor trust.[1]

The IRS also has determined that the distribution of qualified replacement property by a trust to its beneficiary was not a disposition for purposes of IRC Section 1042(e); thus, the recapture rules did not apply.[2]

Although the transfer of qualified replacement property to a charitable remainder unitrust technically was a "disposition," it did not result in recapture of the deferred gain, because the donors did not realize gain on the transaction.[3]

Subsequent Dispositions by the ESOP

If, within three years, an ESOP disposes of stock acquired in a sale in which the seller was permitted to defer the recognition of income (as discussed above) and, as a result, the number of the ESOP's shares falls below the number of employer securities held immediately after the sale, or the value is less than 30 percent of the total value of all employer securities, the disposition will be subject to a tax equal to 10 percent of the amount realized on the disposition, unless the disposition is a distribution made by reason of (1) the death or disability of an employee, (2) retirement of the employee after age 59½, or (3) separation of the employee from service for any period that results in a one year break in service.[4]

3746. How much may an employer deduct for its contributions to an ESOP?

The deduction rules that apply to profit sharing, stock bonus, and money purchase pension plans (Q 3695) generally apply to employee stock ownership plans ("ESOPs") (Q 3739) with a few exceptions that expand how much can be deducted. A C corporation with an ESOP is permitted to deduct additional amounts without regard to the deduction limits for profit sharing, stock bonus, and pension plans to the extent such additional amounts do not exceed the IRC Section 415 limits. The rules that follow generally are not available to ESOPs maintained by an S corporation.[5]

An employer's ESOP contributions that are used to repay the principal of a loan incurred to acquire employer securities are deductible up to 25 percent of the compensation paid to covered employees. This deduction limit is measured based on compensation paid in the employer's tax year for which the deduction is taken. To be deductible, the contribution must have been both paid to the trust and applied by the trust to the repayment of the principal by the due date (including extensions) of the tax return for that year. For contributions exceeding 25 percent of compensation, a contribution carryover is permitted in succeeding years in which the 25 percent

1. Let. Ruls. 9141046, 9130027.
2. Let. Rul. 9226027.
3. Let. Rul. 9234023. See also Let. Ruls. 9438012 and 9438021.
4. IRC Sec. 4978.
5. IRC Secs. 404(a)(9)(C), 404(k)(1).

limit is not fully used (but contributions to a defined contribution plan in excess of the IRC Section 415 limits may not be carried over).[1]

In addition, contributions applied by the plan to the repayment of interest on a loan used to acquire employer securities may be deducted without limit in the tax year for which it is contributed if the contribution is paid by the due date (including extensions) for filing the tax return for that year.[2]

Pass Through Dividends

An employer sponsoring an ESOP also may deduct the amount of any dividend paid on stock held by the ESOP on the record date when the dividend is:

(1) paid in cash to the plan participants or their beneficiaries;

(2) paid to the plan and distributed in cash to the participants or their beneficiaries within ninety days after the close of the plan year;

(3) at the election of the participants or their beneficiaries (x) payable as provided in (1) or (2), or (y) paid to the plan and reinvested in qualifying employer securities (in which case the amounts must be fully vested);[3] or

(4) used to make payments on an ESOP loan used to acquire the employer securities with respect to which the dividend is paid.[4]

Dividend payments described in IRC Section 404(k)(2) are not treated as distributions subject to withholding.[5]

Planning Point: Dividends on Section 404(k) stock are not subject to the lower income tax rates enacted in 2003 for other types of dividend payments.[6]

The IRS has issued guidance on numerous issues related to the election that employers can offer participants or their beneficiaries, as described in (3) above.[7]

The deduction for dividends that a participant elects to reinvest in qualifying employer securities, as described in (3) above, is allowable for the taxable year in which the reinvestment occurs or the election is made, whichever is later.[8]

The IRS may disallow the deduction for a dividend under IRC Section 404(k)(1) if the dividend constitutes, in substance, an avoidance or evasion of taxation.[9]

1. Notice 83-10, 1983-1 CB 536, F-1, as modified by Notice 99-44; 1999-2 C.B. 326. See IRC Sec. 404(a)(9)(A).
2. IRC Sec. 404(a)(9)(B).
3. See IRC Sec. 404(k)(7).
4. IRC Sec. 404(k)(2)(A). See also Let. Ruls. 9840048, 9523034, 9439019.
5. IRC Sec. 3405(e)(1)(B)(iv).
6. See IRC Sec. 1(h)(11)(B)(ii)(III).
7. See Notice 2002-2, 2002-1 CB 285.
8. IRC Sec. 404(k)(4)(B).
9. IRC Sec. 404(k)(5)(A); see also Let. Rul. 9304003.

The authority of the IRS to recharacterize excessive dividends paid on ESOP stock as employer contributions was upheld by the Court of Appeals for the Eighth Circuit in a ruling that resulted in disqualification of the ESOP for its resulting failure to meet the IRC Section 415 limits.[1]

3747. What requirements apply when an S corporation maintains an ESOP?

The IRC permits certain qualified retirement plan trusts to be shareholders of S corporations; thus, an S corporation can adopt an ESOP.[2] When a tax-exempt entity (e.g., an ESOP) holds an ownership interest in an S corporation, the distributions from the S corporation received by the tax-exempt entity are not subject to income tax. This unique tax benefit is available to S corporation ESOPS only when certain requirements are met.

First, the IRC restricts the type of entities that can own an interest in an S corporation.

Second, the IRC places certain restrictions on the operation of the ESOP. These operational rules apply to the allocation of S corporation stock within the ESOP to certain individuals, and limit certain tax benefits otherwise available to ESOP sponsors. Those limits apply to the deductions for employer contributions to the plan and for dividends paid on employer securities, and do not permit the rollover of gain on the sale of stock to an ESOP (Q 3679, Q 3746).

Planning Point: Because there is a possibility for abuse of this benefit, the IRS has targeted S corporation ESOPs for special attention.[3]

The IRS has stated that an ESOP may direct certain rollovers of distributions of S corporation stock to an IRA, in accordance with a distributee's election, without terminating the corporation's S election, provided certain requirements are met.[4]

An S corporation that maintains an ESOP also generally is exempt from the requirement that employees be able to demand distribution of employer securities.[5] To do otherwise could violate the IRC limit on the number of shareholders in an S corporation (Q 3741). An ESOP maintained by an S corporation will not be treated as receiving unrelated business income on items of income or loss of the S corporation in which it holds an interest.[6]

Prohibited Allocations of Stock

An ESOP that holds securities consisting of stock in an S corporation also must provide that no portion of the assets of the plan attributable to such securities will accrue or be allocated,

1. *Steel Balls, Inc. v. Comm*. 89 F 3d 841, 96-1 USTC ¶50,309 (8th Cir. 1996), *aff'g* TC Memo 1995-266. See also *Hollen v. Comm'r*, T.C. Memo 2011-2 (2011), *aff'd*, 437 Fed. Appx. 525 (8th Cir. 2011), *cert. denied*, 132 S. Ct. 2443 (2012).
2. See IRC Sec. 1361(c)(6); Senate Committee Report for SBJPA '96.
3. Rev. Rul. 2004-4, 2004-1 C.B. 414.
4. See Rev. Proc. 2004-14, 2004-7 IRB 489.
5. See IRC Sec. 409(h)(2)(B).
6. IRC Sec. 512(e)(3).

directly or indirectly, to a "disqualified person" during a "nonallocation year."[1] Such an allocation is referred to as a prohibited allocation.

A disqualified person is any person for whom:

(1) the number of the person's deemed-owned ESOP shares is at least 10 percent of the number of deemed-owned ESOP shares of the S corporation,

(2) the aggregate number of the person's deemed-owned ESOP shares and synthetic equity shares is at least 10 percent of the aggregate number of deemed-owned ESOP shares and synthetic equity shares of the S corporation,

(3) the aggregate number of deemed-owned ESOP shares of the person and his or her family is at least 20 percent of the number of deemed-owned ESOP shares of stock in the S corporation, or

(4) the aggregate number of deemed-owned ESOP shares and synthetic equity shares of the person and his or her family is at least 20 percent of the aggregate number of deemed-owned ESOP shares and synthetic equity shares of the S corporation.[2]

Family member means the individual's spouse, an ancestor or lineal descendant of the individual or spouse, a sibling of the individual or spouse, and lineal descendants of any siblings, as well as spouses of the aforementioned individuals (except in the case of a legal separation or divorce).[3]

Deemed-owned shares with respect to any person are the stock in the S corporation constituting employer securities of an ESOP that is allocated to such person's account under the plan, and the person's share (based on the same proportions as of the most recent allocation) of the stock in the corporation that is held by the ESOP but that is not allocated under the plan to participants.[4]

A nonallocation year means any plan year of the ESOP if, at any time during the year, the ESOP holds any employer securities that are shares in an S corporation and disqualified persons own at least 50 percent of the number of outstanding shares in the S corporation (including deemed owned shares) or the aggregate number of outstanding shares of stock (including deemed owned shares) and synthetic equity in the S corporation.[5] For purposes of determining whether there is a nonallocation year, the attribution rules of IRC Section 318(a) apply in determining stock ownership (except that the broader "family member" rules above apply), the IRC Section 318(a) rules regarding options do not apply, and an individual is treated as owning "deemed-owned" shares.[6]

1. IRC Secs. 409(p), 4975(f)(7); Treas. Reg. §1.409(p)-1(b)(1).
2. Treas. Reg. §1.409(p)-1(d)(1); see IRC Secs. 409(p)(4)(A), 409(p)(4)(B).
3. IRC Sec. 409(p)(4)(D); Treas. Reg. §1.409(p)-1(d)(2).
4. IRC Sec. 409(p)(4)(C), Treas. Reg. §1.409(p)-1(e).
5. IRC Sec. 409(p)(3)(A); Treas. Reg. §1.409(p)-1(c)(1).
6. IRC Sec. 409(p)(3)(B); Treas. Reg. §1.409(p)-1(c)(2).

In the event that a prohibited allocation is made in a nonallocation year to a disqualified person, the plan will be treated as having distributed the amount of the allocation to the disqualified person on the date of the allocation.[1] In other words, the allocation is a taxable distribution to the individual.[2] Furthermore, an excise tax of 50 percent of the amount involved is imposed on the allocation, and a 50 percent excise tax is imposed on any synthetic equity owned by a disqualified person.[3] The 50 percent excise taxes are imposed against the employer sponsoring the plan.[4]

Synthetic equity includes any stock option, warrant, restricted stock, deferred issuance stock right, stock appreciation right payable in stock, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Synthetic equity also includes a right to a future payment (payable in cash or any other form other than stock of the S corporation) that is based on the value of the stock of the S corporation or appreciation in such value, or a phantom stock unit.[5]

Synthetic equity also includes any remuneration under certain nonqualified deferred compensation arrangements for services rendered to the S corporation or a related entity.[6] The stock upon which synthetic equity is based will be treated as outstanding stock of the S corporation and deemed-owned shares of the person owning the synthetic equity, if such treatment results in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year.[7]

Final regulations explaining the prohibited allocation rules of the IRC apply to plan years beginning on or after January 1, 2016.[8] For plan years beginning before January 1, 2016, temporary regulations explain the prohibited allocation rules.[9]

S Corporation Plans

3748. What special requirements apply to plans covering shareholder-employees of S corporations?

With respect to qualification, plans of an S corporation (whether defined benefit or defined contribution) generally must meet the same requirements applicable to other corporate plans (Q 3758). The special rules that apply to S corporation ESOPs are explained at Q 3747.

Probably the only significant difference from other entities is in the way that the owner's compensation is treated for plan purposes. Only wages paid to an S corporation shareholder generally may be included in compensation for purposes of determining contributions,

1. IRC Sec. 409(p)(2)(A).
2. For details on the application of this rule, see Treas. Reg. §1.409(p)-1(b).
3. IRC Sec. 4979A(a).
4. IRC Sec. 4979A(c).
5. IRC Sec. 409(p)(6)(C); Treas. Reg. §1.409(p)-1(f)(2).
6. See Temp. Treas. Reg. §1.409(p)-1T(f)(2)(iv); TD 9082, 2003-2 C.B. 420.
7. IRC Sec. 409(p)(5).
8. For details see Treas. Reg. §1.409(p)-1(i)(2).
9. See Temp. Reg. §1.409(p)-1T(i)(2).

nondiscrimination testing, and classification of key or highly compensated employees. That is, S corporation distributions are not included. In contrast, the K-1 income paid to a member in an LLC or a partner in a partnership is treated as contributions for plan purposes. Certain abusive S corporation ESOPs will not be treated as qualified plans, will be subject to prohibited transaction penalties (Q 3871), and are among the "listed transactions" treated as corporate tax shelters (subject to additional penalties).[1]

Keogh Plans

3749. What special qualification rules apply to Keogh plans?

A Keogh plan, which at one time was called an HR-10 plan, is a qualified plan that covers self-employed individuals such as partners in a partnership or sole proprietors. As a general rule, a qualified trust must be established by an employer for the exclusive benefit of the employer's employees or their beneficiaries.[2] Self-employed individuals (sole proprietors, partners in a partnership, or members in an LLC) are not common law employees (Q 3825). For the purpose of allowing such individuals to participate in qualified plans and to enjoy the tax advantages available to other participants in such plans, the law confers employee status on these individuals. The IRC says that for purposes of IRC Section 401, the term "employee" includes for any taxable year an individual who has "earned income."[3]

The term earned income means, in general, net earnings from self-employment in a trade or business in which personal services of the individual are a material income-producing factor.[4] Thus, a partner who has contributed capital to the firm but renders no personal services for it has no "earned income" from the firm and cannot participate in a qualified plan of the partnership.[5]

In arriving at the net earnings that are used to determine a self-employed individual's own contribution, business expenses, including contributions to the plan on behalf of regular employees, are deducted. The definition of earned income of a self-employed person (which is reported on Schedule K1 for a partner) does not include a deduction for the contributions to the plan on behalf of the self-employed individual. The self-employed individual reports his or her own contribution on a Form 1040 individual income tax filing.[6] A partner's earned income is his or her share of partnership net income, including any draw or "salary" the partner receives.[7]

All of the requirements for qualified retirement plans covering common law employees apply equally to plans that cover self-employed individuals. A plan covering only a sole proprietor, or a sole proprietor and his or her spouse, or partners in partnerships (and their spouses) generally is exempt from ERISA requirements.[8]

1. See Rev. Rul. 2003-6, 2003-3 IRB 286.
2. IRC Sec. 401(a)(2).
3. IRC Sec. 401(c)(1).
4. IRC Sec. 401(c)(2).
5. Treas. Reg. §1.401-10(c)(3).
6. IRC Secs. 401(c)(2)(A)(v), 404(a)(8)(C).
7. IRC Secs. 401(c)(2), 1402(a).
8. ERISA Regs. §2510.3-3(b).

Calculating the Contribution

The calculation of the contribution for the self-employed individual involves two unique calculations that do not apply to common law employees: the calculation of self-employment taxes, and the contribution calculation.

The earned income from a business is used to calculate the self-employment taxes that are due on the earned income. These taxes are similar to FICA taxes but are determined in a special calculation that is described in the regulations. It generally is referred to as the Section 164(f) deduction and is one half of the individual's self-employment taxes. This amount reduces the amount of earned income available to calculate the self-employed individual's own contribution.

Contributions on behalf of a self-employed individual may be made only with respect to his or her "earned income" (as defined above) after a reduction for one-half of the self-employment taxes and the contribution itself. That is, the computation of the earned income that is used to determine the individual's contributions is based on earned income less the contribution made to the plan on his or her own behalf. Thus, for example, a common law employee would need only $208,000 of compensation to support a deductible contribution of $52,000 to a defined contribution plan in 2014 ($208,000 × 25% = $52,000) (Q 3695). A self-employed individual would need net earnings of $260,000 ($208,000 plus $52,000) or more to receive a contribution of the same amount.[1]

Matching contributions that are in effect made by the partner, other than QMACs (Q 3776), are not treated as elective deferrals for purposes of the limit on such deferrals under IRC Section 402(g) (Q 3705, Q 3731).[2] Rather, they are treated as employer contributions for all plan purposes.

3750. What rules govern the deduction for contributions by a self-employed individual to a Keogh plan?

The deduction for any employee being paid on a W-2 basis is the same whether to a plan of a corporation or to a Keogh plan. The calculation of deductible contribution for a self-employed individual to a Keogh plan works in a backward way. "Compensation" for all purposes of meeting the IRC's qualification requirements, as they apply to a self-employed individual, is based on earned income after a deduction for one-half self-employment taxes and the self-employed individual's own contribution. Each self-employed individual will require a separate contribution calculation. The contribution is not reported as an employer contribution on the partnership's tax return. Each partner's contribution to a profit sharing plan can be determined without respect to what the other participants are doing or what the plan requires. This means that one does not know what the self-employed's compensation is for meeting the various IRC limits until after the self-employed's contribution is determined. Thus, although a W-2 employee may receive up to 25 percent of compensation as a contribution, the self-employed individual

1. IRC Sec. 401(d); IR-2013-86 (Oct. 31, 2013).
2. IRC Sec. 402(g)(8).

has a 20 percent gross earned income limit. The 20 percent of gross earned income results in a 25 percent of net earned income calculation.[1]

In determining his or her adjusted gross income, a self-employed person deducts his or her plan contributions directly from gross income; the deduction is allowable whether or not the person itemizes deductions. A partner deducts the portion of the contribution made by the partnership on his or her behalf on his or her own individual return; the contributions are not treated as expenses of the partnership.[2]

Contributions on behalf of a self-employed individual may not be used to create or increase a net operating loss.[3]

Employer contributions allocable to the purchase of life, accident, health, or other insurance on behalf of self-employed persons are not deductible. The cost of such coverage (Q 3843) is subtracted from the full contribution to determine the amount deductible.[4]

If life insurance protection is provided under a plan, the amount to be subtracted is the Table 2001 (or P.S. 58) cost (Q 3843) plus the cost of any contract extras, such as a waiver of premium. If amounts attributable to deductible employee contributions are used to purchase life insurance, the amount to be subtracted is the amount so used.

Insurance Benefits

3751. To what extent can a qualified plan provide life or health insurance benefits for its participants?

According to Treasury regulations, benefits must be merely "incidental" to the primary purpose of a plan. A pension plan exists primarily to provide retirement benefits but it "may also provide for the payment of incidental death benefits through insurance or otherwise."[5] A profit sharing plan is "primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance."[6]

The IRS has ruled that a profit sharing plan containing a medical reimbursement account does not satisfy the qualification requirements where distributions are available only for reimbursement of substantiated medical expenses of the participant, spouse, or dependents. The IRS noted that the plan would violate the nonforfeitability requirement of IRC Section 401(a)(7) and may violate other qualification requirements. The fact that only 25 percent of the plan contributions were used to fund the medical reimbursement account did not change this result.[7]

1. IRC Sec. 404(a)(8)(D).
2. IRC Sec. 62(a)(6); Temp. Treas. Reg. §1.62-1T; Treas. Reg. 1.404(e)-1A(f).
3. IRC Sec. 172(d)(4)(D).
4. IRC Sec. 404(e); Treas. Reg. §1.404(e)-1A(g).
5. Treas. Reg. §1.401-1(b)(1)(i).
6. Treas. Reg. §1.401-1(b)(1)(ii).
7. See Rev. Rul. 2005-55, 2005-33 IRB 284.

In 2004 guidance, the IRS specifically described as "excessive" life insurance coverage on a participant that provided for death benefits in excess of the death benefit provided to the participant under the plan (Q 3735).[1] The IRS added that transactions substantially similar to the example are classified as "listed transactions" if the employer has deducted amounts used to pay premiums on a life insurance contract with a death benefit exceeding the participant's death benefit under the plan by more than $100,000.[2]

Applicability of Limitation

A profit sharing plan may provide for distribution of funds accumulated under a plan after a fixed number of years (no fewer than two), the attainment of a stated age, or on the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.[3] The IRS also has ruled that a plan could permit participants with at least five years of participation to withdraw all employer contributions, including those made during the last two years.[4]

If life or health insurance may be purchased only with funds that have been accumulated for the period required by the plan for the deferment of distributions, there is no limit on the amount of such funds that can be used to purchase life or health insurance. The "incidental" limitation applies if the plan permits the use of funds that have not been so accumulated to purchase such insurance.[5]

The incidental limitation does not apply to life or health insurance bought with non-deductible voluntary employee contributions.[6] Furthermore, the IRS determined that where the demutualization of a company that had been placed in rehabilitation resulted in traditional whole life contracts being restructured into flexible adjustable life contracts, the restructuring would not result, in and of itself, in a violation of the incidental death benefit requirements.[7]

Aside from the foregoing exceptions, the incidental limitation applies to insurance when it is purchased by a qualified plan on the life of a participant and benefits are payable to or for the participant, the participant's estate, or the participant's named beneficiary. The limitation also applies to contracts purchased under a qualified annuity plan.[8]

It would seem a necessary inference from this regulation that the incidental rule would not be applied to the purchase of insurance bought by a profit sharing plan on the life of a key individual responsible for employer profits to indemnify the plan for the premature loss by death of the insured.

1. See Rev. Rul. 2004-20, 2004-10 IRB 546.
2. See Rev. Rul. 2004-20, 2004-10 IRB 546.
3. Rev. Rul. 71-295, 1971-2 CB 184.
4. Rev. Rul. 68-24, 1968-1 CB 150.
5. Rev. Rul. 61-164, 1961-2 CB 99; Rev. Rul. 66-143, 1966-1 CB 79.
6. Rev. Rul. 69-408, 1969-2 CB 58.
7. See Let. Rul. 9339024.
8. Treas. Reg. §1.403(a)-1(d).

The Basic 25 Percent Rule

The basic approach taken by the IRS in determining whether life insurance benefits in a pension plan, or life or health insurance benefits in a profit sharing plan, are incidental begins by determining what proportion the cost of providing such benefits bears to the cost of providing all benefits under the plan. If the cost of providing current life and health insurance benefits generally is less than 25 percent of the cost of providing all the benefits under the plan (both deferred and current), the incidental limitation is satisfied.

Despite the fact that an element of savings is involved in universal life coverage, the IRS has taken the position that universal life coverage must be treated under the rules applicable to term coverage and thus is subject to the 25 percent rule.[1] For purposes of the incidental rule, the IRS defines permanent insurance as insurance on which the premium does not increase and the death benefit does not decrease.[2]

The IRS has informally ruled that a variable contract in which the death benefit might decrease as a result of a decline in cash values and the operation of IRC Section 7702 (Q 64), and unscheduled extra premiums were permitted, would be treated as permanent insurance.[3]

The IRS also has ruled for an insurer where an adjustable life contract was to be used as a funding vehicle for a defined contribution plan. The IRS stated that it would apply the incidental rule it applied in Revenue Ruling 61-164, below. In other words, one-half the premiums paid while the contract was providing lifetime protection plus the whole premium paid while the policy was providing term protection must total less than 25 percent of the total plan contributions to date.[4]

In the case of a plan that provides life insurance benefits, the 25 percent rule is applied to the portion of the premium used to provide current life insurance protection (the cost of the "amount at risk"). In the case of a profit sharing plan that provides health insurance benefits, the 25 percent rule is applied to the entire cost of providing current health insurance protection for participants and their families. Rulings discussed and cited below illustrate the application of the 25 percent requirement in various circumstances.

Profit Sharing Plans—The 50 Percent Test

A profit sharing plan that provides that less than one-half the amount allocated annually to each participant's account will be used to purchase ordinary life insurance on his or her life meets the 25 percent requirement (assuming the plan provides no other current benefits purchased with nondeferred funds). The reason is that by IRS reckoning, on the average, during an employee's working years, about one-half of each annual premium on ordinary life contracts bought by the plan on his or her life is required to pay the cost of current life insurance protection.

1. FSA 1999-633.
2. Ira Cohen, Director, Employee Plans Technical and Actuarial Division, Internal Revenue Service, in response to a question asked at the 29th Annual Meeting of the AALU, 3-4-86.
3. See Let. Rul. 9014068.
4. Let. Rul. 8725088.

In a profit sharing plan funded by a combination of ordinary life policies and a side fund, the aggregate premiums that have been paid (with nonaccumulated funds) for insurance on a participant's life must be at all times less than 50 percent of the aggregate employer contributions and forfeitures (without regard to trust earnings and capital gains and losses) that have been allocated to the participant. The plan also must require the trustee, at or before each employee's retirement, either to convert the employee's policies into cash to provide income (without life insurance protection that continues past the employee's retirement) or to distribute the policies to the employee.[1]

Thus, where at all times cash values under a whole life insurance policy equaled or exceeded the minimum cash values under an ordinary whole life insurance policy and less than 50 percent of the total contributions allocated to the participant were applied to premiums, the IRS determined that the death benefits were incidental.[2]

If the 25 percent requirement is met with respect to insurance purchased by a plan, the plan may pay as a death benefit both the face amount of the insurance and the amount accumulated in the side fund allocated to the participant.[3] There appears to be no reason a profit sharing plan could not provide for the purchase of term insurance (individual or group) rather than ordinary life, so long as aggregate premiums paid for insurance on each participant are less than 25 percent of aggregate employer contributions and forfeitures allocated to him. The IRS has applied the 25 percent limitation in the manner just described to an ordinary life contract to which was added a ten year decreasing term rider in a ratio of one-to-one (i.e., $1,000 initial face amount of term for each $1,000 face amount of ordinary life).[4]

The IRS also has applied the 25 percent limitation as described to a policy combining 70 percent participating whole life and 30 percent one year term insurance under which dividends are used to purchase paid-up additions; as the additions total increases, the amount of term insurance is reduced, so that a level death benefit is provided.[5]

If a profit sharing plan provides for the purchase of both ordinary life and health insurance for participants from funds that have not been accumulated for the period required by the plan for deferment of distributions, the amount expended on health insurance premiums plus one-half the amount expended on ordinary life premiums must not exceed 25 percent of such accumulated funds. For example, assume the account of an employee has been allocated $1,000, no part of which has been accumulated for the requisite period. If $300 is expended for the purchase of ordinary life, not more than $100 may be expended on health insurance.[6]

1. Rev. Rul. 60-84, 1960-1 CB 159; Rev. Rul. 57-213, 1957-1 CB 157; Rev. Rul. 54-51, 1954-1 CB 147; Letter Ruling, 3-14-66, signed by I. Goodman, Chief, Pension Trust Div. of IRS, Spencer's RPS 241-2.
2. Let. Rul. 201043048.
3. Rev. Rul. 73-501, 1973-2 CB 128.
4. Rev. Rul. 76-353, 1976-2 CB 112.
5. Let. Rul. 8029100.
6. Rev. Rul. 61-164, 1961-2 CB 99.

The "100-to-1" Test

In a pension plan of any type, and in a profit sharing plan, on the assumption that there is no other current benefit to be considered, the incidental limitation automatically is satisfied if a death benefit is provided that does not exceed the amount of (1) death benefit that would be paid if all benefits under the plan were funded by retirement income endowment policies that have a death benefit of $1,000, or (2) the reserve, if greater, for each $10 per month of life annuity the policy guarantees at retirement age. The reason is that the IRS has determined that the cost of providing such a death benefit will not in any case exceed 25 percent of the cost of providing all benefits under the plan.[1] This so-called 100-to-1 ratio test therefore is merely a "safe harbor" rule; it is not a limitation on the amount of death benefit that may be provided.

Miscellaneous Rulings

Postretirement death benefits in a pension plan are subject to the incidental limitation, presumably in the same way preretirement death benefits are subject to the limitation.[2] These benefits are to be distinguished from post-death payments derived from amounts accumulated under a plan for payment to a retired employee or his or her beneficiaries (e.g., the annuity paid to the survivor under a joint and survivor annuity). These latter type payments are subject to entirely different rules (Q 3813).

A plan providing only such benefits as are afforded through the purchase of ordinary life contracts, which are converted to annuities at retirement, is not a pension plan within the meaning of the regulations and will not qualify.[3] A prototype pension plan providing for funding solely through ordinary life contracts will not qualify even if it requires the adopting employer to maintain a second plan containing provisions such that, when the two plans are considered as one, the death benefit does not exceed 100 times the monthly retirement annuity.[4]

A pension plan that permits a participant to invest a portion of his or her account in life insurance on the life of anyone in whom he or she has an insurable interest will not qualify because it would provide a benefit that is not "definitely determinable" (Q 3684).[5]

3752. To what extent can an employee stock ownership plan (ESOP) provide life or health insurance benefits for its participants?

The rules applicable to purchases of life insurance by qualified plans (Q 3751) generally apply to employee stock ownership plans (Q 3739).[6] Thus, if assets are invested primarily in qualifying employer securities, life insurance may be purchased on the lives of participants for

1. Rev. Rul. 60-83, 1960-1 CB 157 (profit sharing plan funded by single premium endowment policies maturing at retirement age); Rev. Rul. 61-121, 1961-2 CB 65 (pension plan death benefits based on employee's anticipated retirement income and the past service credits); Rev. Rul. 68-31, 1968-1 CB 151 (money purchase pension plan funded by retirement income policies); Rev. Rul. 68-453, 1968-2 CB 163 (pension plan funded by ordinary life contracts with face amount equaling 100 times anticipated monthly retirement benefit, plus side fund); Rev. Rul. 74-307, 1974-2 CB 126.
2. Rev. Rul. 60-59, 1960-1 CB 154.
3. Rev. Rul. 81-162, 1981-1 CB 169; Rev. Rul. 65-25, 1965-1 CB 173.
4. Rev. Rul. 71-25, 1971-1 CB 115.
5. Rev. Rul. 69-523, 1969-2 CB 90.
6. TD 7506, 1977-2 CB 449.

the benefit of their estates or named beneficiaries within the limits of the 25 percent "incidental" rule described above. Proceeds of an exempt loan (Q 3739) may not be used by an employee stock ownership plan to purchase life insurance.[1]

Planning Point: There appears to be no reason, so long as assets are invested primarily in qualifying employer securities, that an employee stock ownership plan may not purchase key person life insurance in the same way profit sharing plans do, and for essentially the same purpose. Also, should a key person insured be a shareholder, there appears to be no reason death proceeds could not be used to purchase employer stock from his or her estate.

An employee stock ownership plan must not obligate itself to acquire securities from a particular security holder at an indefinite time determined on the happening of an event such as the death of the holder.[2]

3753. To what extent can a money purchase pension plan provide life or health insurance benefits for its participants?

Where life insurance is purchased on the lives of participants in a money purchase pension plan, the 25 percent rule is applied in basically the same way as if the plan were a profit sharing plan (Q 3751). Because a money purchase pension plan is primarily a retirement plan, the incidental limitation applies regardless of whether the plan provides that funds used to purchase insurance must have been accumulated for at least two years.[3]

In a plan funded by a combination of life insurance and a side fund, if the 25 percent requirement is met with respect to the premiums, the plan may provide for a death benefit consisting of both the face amount of the insurance and the amount credited to the participant's account at death.[4]

3754. To what extent can a defined benefit pension plan provide life or health insurance benefits for its participants?

Death benefits under a pension plan of any type will be considered incidental if either (1) less than 50 percent of the employer contribution credited to each participant's account is used to purchase ordinary life insurance even if the total death benefit consists of both the face amount of the insurance and the amount credited to the participant's account at time of death, or (2) such death benefits would be incidental under the "100-to-1" test described in Q 3751.[5]

It is clear, therefore, not only from the foregoing but also from dicta in prior rulings that the 25 percent rule (Q 3751) is intended to apply to life insurance benefits provided in defined benefit pension plans as well as in defined contribution plans. Because in a pension plan "death benefits" must be incidental, it would seem that the 25 percent rule would be applied to the cost of providing the entire death benefit the plan actually pays.

1. TD 7506, 1977-2 CB 449 (Major Revision (9)); Treas. Reg. §54.4975-7(b)(4).
2. Treas. Reg. §54.4975-11(a)(7)(i).
3. Rev. Rul. 66-143, 1966-1 CB 79.
4. Rev. Rul. 74-307, 1974-2 CB 126.
5. Rev. Rul. 74-307, 1974-2 CB 126.

In the case where a plan purchases life insurance on participants' lives and participants have separate accounts, it appears that the 25 percent rule is applied only to the cost of providing current life insurance protection (i.e., the portion of premium paying for the "amount at risk").[1]

3755. When can health insurance benefits be provided under a pension plan?

A pension plan may provide for the payment of a pension due to disability, but it may not provide benefits for sickness, accident, hospitalization, or medical expenses for active plan participants or their beneficiaries.[2] These benefits may be provided for retired employees, their spouses, and their dependents, but only if:

(1) the benefits are subordinate to the retirement benefits provided by the plan,

(2) a separate account is established and maintained for the benefits,

(3) the employer's contributions to the separate account are reasonable and ascertainable,

(4) no part of the account may be diverted to any other purpose,

(5) the plan calls for return to the employer of any amounts remaining after satisfaction of all liabilities, and

(6) in the case of an employee who is a key employee (Q 3828) at any time during the plan year (or any preceding plan year when contributions were made on behalf of such employee), a separate account is established and maintained for the benefits payable to the employee, spouse, and dependents (Q 3756).[3]

Medical benefits generally are considered subordinate to retirement benefits as required under (1) above if, at all times, the aggregate of employer contributions made (after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate pension contributions made after that date (other than contributions to fund past service credits).[4] Details as to the calculation of this limit, as well as the coordination of benefits between an IRC Section 401(h) account and a VEBA (Q 3) have been explained by the IRS.[5]

See Q 3842 and Q 368 for the tax aspects of IRC Section 401(h) contributions and benefits; and see Q 3668 for the effect of IRC Section 401(h) contributions on behalf of key employees on the IRC Section 415 limitation on benefits in a defined benefit plan.

3756. May excess pension assets be transferred to Section 401(h) accounts?

Yes, under certain circumstances.

A "qualified transfer" of "excess pension assets" (see below) from a defined benefit plan to a Section 401(h) account of the same plan will not violate the qualification rules of

1. See also Rev. Rul. 61-164, 1961-2 CB 99; Rev. Rul. 66-143, 1966-1 CB 79; Rev. Rul. 70-611, 1970-2 CB 89.
2. Treas. Reg. §1.401-1(b)(1)(i).
3. IRC Sec. 401(h).
4. IRC Sec. 401(h); Treas. Reg. §1.401-14(c)(1).
5. See Let. Rul. 9834037.

IRC Section 401(a). This kind of transfer will not be treated as an employer reversion (Q 3870) or as a prohibited transaction (Q 3871).[1]

A "qualified transfer" is one that does not contravene any other provision of law (e.g., a collective bargaining agreement under relevant law) and that meets the use, vesting, and minimum cost requirements described below.[2] The rules permitting qualified transfers to Section 401(h) accounts apply for taxable years beginning before January 1, 2022.[3]

If an employer elects to make a qualified transfer, the amount transferred may not exceed an amount that reasonably is estimated to be the amount the employer maintaining the plan will pay (directly or through reimbursement) out of the Section 401(h) account during the taxable year for qualified current retiree health liabilities.[4] The amount of the qualified transfer may be based on amounts the employer paid during the taxable year before the date of the transfer and prior to the establishment of the Section 401(h) account as long as the account is established prior to the transfer and before the end of such taxable year.[5] In addition, no more than one transfer per plan per taxable year may be treated as a qualified transfer.[6] Section 420 qualified transfers (but not qualified future transfers) are available to multiemployer plans in plan years beginning after 2006.[7]

A qualified transfer must meet the following three requirements:

(1) Use requirement—Assets transferred to a Section 401(h) account may be used only to pay qualified current retiree health liabilities for the taxable year of the transfer.[8] Qualified current retiree health liabilities do not include amounts provided for health benefits to retired key employees.[9] Amounts not used to pay for health benefits or life insurance must be transferred back to the transferor plan and are not includable in the gross income of the employer for such taxable year, but are treated as an employer reversion and subject to the 20 percent penalty.[10]

(2) Vesting requirement—The plan generally must provide that the accrued pension benefits of any participant or beneficiary under the plan become nonforfeitable as if the plan had terminated immediately before the qualified transfer (or in the case of a participant who separated during the one year period ending on the date of the transfer, immediately before the separation).[11]

(3) Minimum cost requirement—Each group health plan or arrangement under which applicable health benefits or life insurance benefits are provided must provide that

1. IRC Sec. 420(a).
2. See IRC Sec. 420(b)(1)(C).
3. IRC Sec. 420(b)(4).
4. IRC Sec. 420(b)(3).
5. See IRS General Information Letter, 5 Pens. Pl. Guide (CCH) ¶17,381I (July 5, 1991).
6. IRC Sec. 420(b)(2).
7. See IRC Sec. 420(f)(2)(E).
8. IRC Sec. 420(c)(1).
9. IRC Sec. 420(e)(1)(D), (E).
10. IRC Sec. 420(c)(1)(B).
11. IRC Sec. 420(c)(2).

> the applicable employer cost (see below) for each taxable year during the "cost maintenance period" will not be less than the higher of the applicable employer cost for each of the two taxable years immediately preceding the taxable year of the qualified transfer. The "cost maintenance period" means the period of five taxable years beginning with the taxable year in which the qualified transfer occurs. If a taxable year is in two or more overlapping cost maintenance periods, the highest applicable employer cost required during the taxable year will be taken into account for purposes of this rule.[1]

Regulations state that an employer who significantly reduces retiree health coverage during the cost maintenance period will not satisfy the minimum cost requirement.[2] A retiree health coverage reduction is significant if, for any taxable year during the cost maintenance period, either the employer-initiated reduction percentage for the taxable year exceeds 10 percent or the sum of such percentages for that taxable year and all prior taxable years during the cost maintenance period exceeds 20 percent.[3]

The term "excess pension assets" generally means the excess of the lesser of the fair market value of the plan's assets or the value of such assets determined under the minimum funding rules over 125 percent of the current liability of the plan (as determined for purposes of the full funding limitation) (Q 3689).[4]

Applicable employer cost means the amount determined by dividing the qualified current retiree health liabilities of the employer for the taxable year by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year. For this purpose, the amount of qualified current retiree health liabilities is determined without regard to reductions for amounts previously set aside. If there was no qualified transfer during the taxable year, the qualified current retiree health liabilities amount is determined as though there had been such a transfer at the end of the taxable year.[5]

For transfers made after August 17, 2006, an employer maintaining a defined benefit plan other than a multiemployer plan may elect to make a qualified future transfer or qualified collectively bargained transfer in lieu of a qualified transfer. Excess pension assets, for purposes of qualified future transfers, are calculated by substituting 120 percent for 125 percent of plan liability, and the amount of excess pension assets that may be transferred is increased to the sum of the qualified retiree health liabilities for all the taxable years during the transfer period. The transfer period is not less than two and not more than ten consecutive taxable years.[6]

An employer generally may not contribute to a Section 401(h) account or a welfare benefit fund with respect to qualified current retiree health liabilities for which transferred assets

1. IRC Sec. 420(c)(3).
2. Treas. Reg. §1.420-1(a).
3. See Treas. Reg. §1.420-1(b).
4. IRC Sec. 420(e)(2).
5. IRC Sec. 420(c)(3)(B).
6. See IRC Secs. 420(f)(2)(B); 420(f)(5).

are required to be used.[1] In addition, the amount that can be transferred in a qualified transfer is reduced if the employer previously has made a contribution to a Section 401(h) account or welfare benefit fund for the same liabilities.[2]

The Moving Ahead for Progress in the 21st Century Act (MAP-21), enacted in 2012, also permits the transfer of excess pension assets (up to $50,000 per participant) for retiree life insurance benefits.[3]

In addition, ERISA requires that notice of any qualified transfer be given to plan participants, the DOL, and the IRS at least sixty days before the date of the qualified transfer;[4] the Department of Labor and Treasury have agreed that one notice filed with the DOL within the requisite period will satisfy this requirement.[5] Penalties of up to $110 a day may be imposed on any plan administrator or employer for failure to provide the required notice.[6]

Qualification

3757. What are the advantages of a qualified pension, annuity, profit sharing, or stock bonus plan?

The term "qualified plan" refers to an employer sponsored retirement plan meeting the requirements of IRC Section 401. Section 401 not only provides for an extensive list of requirements incorporating additional IRC sections, but it also conveys uniquely favorable tax treatment to employers and covered employees and their beneficiaries as long as those requirements continue to be met. This section (Q 3757 to Q 3833) explains the basic qualification requirements that apply to all qualified plans. The additional plan-specific qualification requirements that apply only to certain types of plans are explained beginning at Q 3665.

Assuming the qualification requirements set forth in the IRC are met, the following tax advantages are available for qualified plans:

(1) An employer can take a current business expense deduction (within limits) for its contributions to the plan even though employees are not currently taxed on these contributions (Q 3834 to Q 3839);

(2) An employee pays no tax until benefits are distributed regardless of whether he or she has a forfeitable or non-forfeitable right to the contributions made on his or her behalf (Q 3842);

(3) Distributions meeting certain requirements may be eligible for rollover or special tax treatment (Q 3859 to Q 3863);

1. IRC Sec. 420(d)(2).
2. See IRC Sec. 420(e)(1)(B); see also, IRS General Information Letter, 5 Pens. Pl. Guide (CCH) ¶17,381I (July 5, 1991).
3. Public Law 2012-141, §40242.
4. ERISA Sec. 101(e).
5. Ann. 92-54, 1992-13 IRB 35.
6. ERISA Sec. 502(c).

(4) Annuity and installment payments are taxable only as received (Q 539 to Q 3860, Q 3866);

(5) The fund within the plan earns and compounds income on a tax deferred basis (Q 3869); and

(6) Certain small employers (i.e., employers with fewer than 100 employees earning compensation over $5,000 per year) may be able to claim a business tax credit equal to 50 percent of qualified start-up costs of up to $500 per year for three years of an eligible employer plan.[1]

The PPACA[2] ("Health Care Act") added IRC Section 45R, which generally provides a small employer health insurance credit equal to 50 percent (35 percent for small tax-exempt employers) of the aggregate amount of non-elective employer contributions for premiums for qualified health plans offered to employees. The credit is phased out based on the number of employees and amount of wages. The credit is available for tax years beginning in 2010 and thereafter. In addition, ERISA provides creditor protection to accounts, even in the case of bankruptcy, though levies and fines may be chargeable against a participant's account.[3]

Self-employed persons (i.e., sole proprietors and partners) (Q 3829) may participate in qualified plans as "employees." There are special rules applicable to self-employed individuals (Q 3748 to Q 3750).

3758. What requirements must be met for a plan to be qualified?

A new retirement plan is tax qualified when the plan document complies with the requirements under IRC Section 401(a). The document must be updated periodically to meet this section's changing requirements, and the plan must be operated in compliance with the IRC and the document. A plan that fails to meet these requirements, either in its document or operation, has a document failure or an operational failure, respectively. A plan that does not correct either failure could be disqualified by the IRS. An IRS disqualification strips the plan of its tax benefits. Most document or operational failures can be corrected through one of the IRS' voluntary correction programs under the Employee Plans Compliance Resolution System ("EPCRS").[4]

To meet the basic qualification requirements of IRC Section 401(a), a plan must:

(1) be established in the United States by an employer for the benefit of employees or their beneficiaries (Q 3759);

(2) prohibit the use of plan assets for purposes other than the exclusive benefit of the employees or their beneficiaries until such time as all liabilities to employees and their beneficiaries have been satisfied (Q 3759);

1. For details, see IRC Sec. 45E.
2. Public Law 111-148.
3. ERISA Sec. 206(d).
4. For details, see Rev. Proc. 2008-50, 2008-35 IRB 464, as modified and superseded by Rev. Proc. 2013-12, 2013-4 IRB 313.

(3) meet minimum age and service standards (Q 3761), and minimum coverage requirements (Q 3762);

(4) provide for contributions or benefits that are not discriminatory (Q 3764 to Q 3779 in general, and Q 3731 to Q 3732 with respect to 401(k) plans);

(5) provide for contributions or benefits that do not exceed the IRC Section 415 limitations (Q 3784, Q 3668, and Q 3677);

(6) meet minimum vesting standards (Q 3785 to Q 3786);

(7) provide for distributions that satisfy both the commencement rules and the minimum distribution requirements (Q 3801 to Q 3814);

(8) provide for automatic survivor benefits under certain circumstances (Q 3791 to Q 3800);

(9) contain provisions that meet the requirements for "top-heavy" plans and provide that these provisions will become effective should the plan become top-heavy (Q 3817 to Q 3823);

(10) prohibit the assignment or alienation of benefits (Q 3815 to Q 3816);

(11) meet the miscellaneous requirements described in Q 3824;

(12) meet the plan-specific requirements that are based on the type of plan (e.g., profit sharing) (Q 3665 to Q 3749);

(13) provide that if the distributee of an eligible rollover distribution elects to have the distribution as permitted under IRC Section 401(a)(31)(A) paid as a direct rollover, the distribution will be made in the form of a direct rollover;

(14) if the plan uses the forced distribution provision of IRC Section 401(a)(31)(B) for distributions of vested benefits that do not exceed $5,000, the plan also must notify the distributee in writing of the rollover (Q 3884);[1]

(15) provide to each recipient of a plan distribution a written explanation of his or her right to elect a direct rollover and the withholding consequences of not making the election prior to making the distribution (Q 3882);[2]

(16) be established through a written plan document that is communicated to employees prior to the first day of the plan year for which it is to be effective. This document must satisfy the requirements of 401(b). In most cases, plan sponsors rely on either a determination letter or other IRS approval to confirm that the form of

1. IRC Sec. 401(a)(31)(B).
2. IRC Sec. 402(f).

the document is in compliance. Prototype and volume submitter documents have a form or preapproval by the IRS;[1]

(17) if the plan holds assets in a custodial account, that account must be with a bank or other entity who demonstrates to the satisfaction of the IRS that assets will be properly held;

(18) if the plan covers employees who are covered under a collectively bargained plan, then the requirements of IRC Section 413 must be met; and

(19) if the plan covers self-employed individuals, it must meet the requirements discussed under Q 3748, Q 3749, and Q 3829.

Although a document must fully satisfy the provisions of 401(a) on the date of adoption, changing legislation and Treasury regulations may require amendments prior to the close of a specific plan year. Just about every plan needs some required plan amendment every year.

Failure to timely amend a plan to meet newly enacted or modified qualification requirements can result in revocation of a plan's qualified status,[2] even if the plan has been terminated.[3] Nonetheless, a terminated plan is subject to meeting the IRC's qualification rules until such time as all the assets are distributed in satisfaction of its liabilities.

Exclusion Benefit Rule

3759. What is the exclusive benefit rule of plan qualification?

A plan must be established in the United States by an employer for the exclusive benefit of employees or their beneficiaries.[4]

A plan will not qualify if it includes participants who are not employees of the employer that established and maintains the plan except in the case of "leased employees" (Q 3826).[5] An individual generally is an employee for the purpose of participating in a qualified plan if he or she is an employee under common law rules (Q 3825); however, under IRC Section 3508, certain real estate agents and direct sellers of consumer products are specifically defined as non-employees. An individual is an employee under the common law rules if the person or organization for whom he or she performs services has the right to control and direct his or her work, not only as to the result to be accomplished but also as to the details and means by which the result is accomplished.[6]

Self-employed individuals are eligible to participate in their own qualified plans under the same rules applicable to common law employees, although some special rules apply (Q 3749, Q 3829). Participation by independent contractors who are not employees of a corporation in

1. *Engineered Timber Sales, Inc. v. Comm.*, 74 TC 808 (1980), appeal dismissed (5th Cir. 1981); *G&W Leach Co. v. Comm.*, TC Memo 1981-91.
2. *Christy & Swan Profit Sharing Plan v. Commissioner*, T.C. Memo. 2011-62.
3. See *Basch Eng'g, Inc. v. Comm.*, TC Memo 1990-212; *Fazi v. Comm.*, 102 TC 695 (1994).
4. IRC Sec. 401(a).
5. Rev. Rul. 69-493, 1969-2 CB 88.
6. Treas. Reg. §31.3121(d)-1(c)(2); *Packard v. Comm.*, 63 TC 621 (1975).

a corporation's plan generally would be a violation of the exclusive benefit rule; however, the IRS has not been inclined to disqualify plans on this ground alone.[1]

Stockholders, even sole owners of corporations, who are bona fide employees of corporations (including professional corporations and associations and S corporations) are eligible to participate in a qualified plan of the corporation as regular employees, not as self-employed individuals.[2] A full-time life insurance salesperson who is an employee for Social Security purposes can participate in a qualified plan as a regular employee.[3] He or she cannot set up a plan as a self-employed individual.[4]

The primary purpose of benefiting employees or their beneficiaries must be maintained with respect to investment of trust funds as well as with respect to other activities of the trust.[5]

The use of the exclusive benefit rule to disqualify a plan where trust funds have been misappropriated generally occurs only under egregious circumstances. For example, where a plan loaned out almost all of its assets to the company president without seeking adequate security, a fair return, or prompt repayment, the plan was held not to be operated for the exclusive benefit of the employees and the plan was disqualified.[6]

Likewise, where a corporation's sole shareholder and plan trustee caused the plan to make twenty-two unsecured loans to himself and none of the loans bore a reasonable rate of interest or were adequately secured, the exclusive benefit rule was violated and the plan disqualified.[7]

A loan made by a plan to an employer from excess funds that would have been returned to the employer did not violate the exclusive benefit requirement despite the imposition of the excise tax on prohibited transactions.[8]

The Tax Court has held that even a violation of the prudent investor rule (i.e., a failure to diversify) did not violate the exclusive benefit rule.[9]

The IRS has decided that where an ESOP trust contained a provision permitting the trustee to consider nonfinancial, employment-related factors in evaluating tender offers for company stock, the exclusive benefit rule was violated.[10]

1. See e.g., *Lozon v. Comm.*, TC Memo 1997-250.
2. Treas. Reg. §1.401-1(b)(3); Rev. Rul. 63-108, 1963-1 CB 87; Rev. Rul. 55-81, 1955-1 CB 392; *Thomas Kiddie, M.D., Inc. v. Comm.*, 69 TC 1055 (1978).
3. See IRC Sec. 7701(a)(20).
4. Treas. Reg. §1.401-10(b)(3).
5. Rev. Rul. 73-380, 1973-2 CB 124; Rev. Rul. 73-282, 1973-2 CB 123; Rev. Rul. 73-532, 1973-2 CB 128; Rev. Rul. 69-494, 1969-2 CB 88; *Feroleto Steel Co. v. Comm.*, 69 TC 97 (1977); *Bing Management Co., Inc. v. Comm.*, TC Memo 1977-403.
6. *Winger's Dept. Store, Inc. v. Comm.*, 82 TC 869 (1984).
7. TAM 9145006; see also TAM 9701001.
8. See TAM 9430002.
9. See *Shedco, Inc v. Comm.*, TC Memo 1998-295.
10. GCM 39870 (4-17-92).

The garnishment of an individual's plan interest under the Federal Debt Collections Procedures Act ("FDCPA") to pay a judgment for restitution or fines will not violate the exclusive benefit rule.[1]

3760. Can a qualified plan permit reversion of plan funds to the employer and still satisfy the exclusive benefit rule?

It must be impossible under a plan at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries for any part of the funds to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.[2] (See Q 3759).

As a rule, therefore, no sums may be refunded to the employer. A plan may provide for the return of a contribution (and any earnings) where the contribution is conditioned on the initial qualification of the plan, the plan receives an adverse determination with respect to its qualification, and the application for determination is made within the time prescribed by law for filing the employer's return for the taxable year in which the plan was adopted or a later date as the Secretary of Treasury may prescribe.[3]

A plan also may provide for return to the employer of contributions made by reason of a good faith mistake of fact and of contributions conditioned on deductibility where there has been a good faith mistake in determining deductibility.[4] Earnings attributable to any excess contribution based on a good faith mistake may not be returned to the employer, but losses attributable to such contributions must reduce the amount returned.[5]

Employer contributions made to satisfy the quarterly contribution requirements (Q 3673) may revert to the employer if the contribution is conditioned on its deductibility, a requested letter ruling disallows the deduction, and the contribution is returned to the employer within one year from the date of the disallowance of the deduction.[6] Documentation must be provided showing that the contribution was conditioned on deductibility at the time it was made; board resolutions dated after the contribution is made are not sufficient.[7] A letter ruling request may not be needed if the employer contribution is less than $25,000 and certain other requirements are met.[8]

If, on termination of a pension plan (other than a profit sharing plan), all fixed and contingent liabilities to employees and their beneficiaries have been satisfied, the employer may recover any surplus existing because of actuarial "error."[9] The plan must specifically provide for

1. Let. Rul. 200426027.
2. IRC Sec. 401(a)(2).
3. Rev. Rul. 91-4, 1991-1 CB 54; see also ERISA Sec. 403(c)(2)(B).
4. Let Rul. 201208043.
5. Rev. Rul. 91-4, above; see also ERISA Secs. 403(c)(2)(A), 403(c)(2)(C).
6. Rev. Proc. 90-49, 1990-2 CB 620.
7. Let. Ruls. 9021049, 8948056.
8. See Rev. Proc. 90-49, above, Sec. 4.
9. Treas. Reg. §1.401-2(b); Rev. Rul. 70-421, 1970-2 CB 85; Rev. Rul. 83-52; 1983-1 C.B. 87, modified by Rev. Rul. 85-6; 1985-1 C.B. 133.

such a reversion.[1] Thus, where a plan had no such provision, the employer was required to distribute surplus assets to the former employees (or their surviving spouses) covered by the plan.[2] Furthermore, the calculation of the employees' share of residual assets must result in an equitable distribution before the surplus assets may revert to the employer.[3] An excise tax may apply to any employer reversion (Q 3870).

If a pension or annuity plan maintains a separate account that provides for the payment of medical benefits to retired employees, their spouses, and their dependents, any amount remaining in such an account following the satisfaction of all liabilities to provide the benefits must be returned to the employer even though liabilities exist with respect to other portions of the plan.[4]

Minimum Participation and Coverage

3761. What are the age and service requirements that can be used for qualified plans?

A plan document need not set any threshold for employees to meet before becoming eligible to participate in the plan. That is, every employee could be eligible on being hired.

Most employers, however, favor requiring a new employee to work for a period of time and to attain a specific age before he or she is eligible to participate. The longest period and oldest age that may be set in a plan document is established by the IRC and is referred to as minimum age and service.

Under the rules, a plan generally may not require that an employee complete a period of service extending beyond the later of age 21 or the completion of one year of service. The one year period may be extended to two years if the plan provides that after not more than two years of service each participant has a non-forfeitable right to 100 percent of the accrued benefit.

In the case of a plan maintained exclusively for employees of a tax-exempt (under IRC Section 501(a)) educational institution, the minimum age limitation can be twenty-six instead of twenty-one, but only if the plan provides that each participant having at least one year of service has a non-forfeitable right to 100 percent of the accrued benefit.[5]

A plan must provide that any employee who has satisfied the IRC's minimum age and service requirements specified above (and who is not otherwise excluded as a class) is eligible to participate in the plan no later than the earlier of the first day of the first plan year beginning after the date on which the employee satisfied such requirements, or the date six months after

1. See ERISA Sec. 4044(d)(1).
2. *Rinard v. Eastern Co.*, 978 F.2d 265 (6th Cir. 1992).
3. See *Holland v. Amalgamated Sugar Co.*, 787 F. Supp. 996 (D.C. Utah 1992), *rev. & remanded*, 22 F.3d 968 (10th Cir. 1994).
4. IRC Sec. 401(h)(5).
5. IRC Secs. 401(a)(3), 410(a)(1). See Temp. Treas. Reg. §1.410(a)-3T.

the date on which the employee satisfied such requirements.[1] Special rules apply to calculation of service for this purpose.[2]

Plans can use shorter periods and younger ages, and some designs favoring high paid owners have every employee enter the plan, even those who, by the nature of their job, would never obtain a vested benefit. In a 2004 memorandum to its staff, the IRS expressed disapproval with these and other plan designs that attempt to satisfy various IRC requirements by opening participation to rank and file employees with very short periods of service. These plans may be the subject of adverse rulings or other action.[3]

Not all employees meeting a plan's age and service requirements will be eligible for plan participation. Other requirements not related to age or service may be imposed by a plan as a condition of participation.[4] These individuals are referred to as excluded employees. For example, it is possible to structure a plan that is limited only to salaried employees, although additional testing will generally be required (Q 3762). Nevertheless, if the effect of a plan provision is to impose an additional age or service requirement, that provision will be treated as an age or service requirement even if it does not specifically refer to age or service.[5] The IRS has stated that this problem exists when a plan document excludes "part-time" employees from the plan. These provisions are treated as violating the minimum age and service rules under IRC Section 410(a) even if they otherwise would satisfy minimum coverage under IRC Section 410(b).[6]

The year of service for determining eligibility generally means a twelve month period, measured from the date the employee became employed, during which the employee has worked at least 1,000 hours. This is referred to as the hours of service method of determining years of service.

A plan may require less, but not more, than 1,000 hours in a twelve month period to determine the threshold for being credited with a year of service.

Another method that may be used to calculate a year of service looks at the period from hire to a "separation of service" to see if the twelve month period has passed. This is referred to as the elapsed time method.[7]

In addition, special rules apply where there are breaks-in-service and where there is absence from work due to pregnancy, childbirth, or adoption of a child.[8] Special rules also apply in the cases of seasonal industries and maritime industries.[9]

1. IRC Sec. 410(a)(4).
2. IRC Sec. 410(a)(3).
3. Memorandum dated October 22, 2004, Carol D. Gold, Director Employee Plans.
4. Treas. Reg. §1.410(a)-3(d).
5. Treas. Reg. §1.410(a)-3(e)(1).
6. IRS Field Directive (November 22, 1994), CCH Pension Plan Guide ¶23,902F; see also TAM 9508003; 1995 FSA LEXIS 8.
7. Treas. Reg. §§1.410(a)-7, Temp. Treas. Reg. 1.410(a)-9T.
8. IRC Secs. 410(a)(3), 410(a)(5)(E); Treas. Regs. §§1.410(a)-5, 1.410(a)-6. See Temp. Treas. Reg. §1.410(a)-8T, Treas. Reg. §1.410(a)-9.
9. IRC Secs. 410(a)(3)(B), 410(a)(3)(D); Treas. Reg. §1.410(a)-5.

Service with former employers may be credited for the purpose of determining eligibility to participate in a plan provided the former employers are specified in the plan or trust, all employees having such past service are treated uniformly, and the use of the past service factor does not produce discrimination in favor of highly compensated employees (Q 3764).[1] The IRS also has permitted individuals to be credited for services performed as partners or sole proprietors before becoming employees in a successor corporation for this purpose.[2] Companies working with the Defense Department frequently will credit service within the armed forces for eligibility or vesting.

3762. What is the minimum coverage requirement for qualified plans?

Understanding how a plan can meet the IRC's minimum coverage requirements may be one of the more difficult concepts to master in regard to qualified plans.

Satisfying the minimum coverage of IRC Section 410(b) differs from satisfying the age and service requirements of IRC Section 410(a) because coverage looks to see if individuals who have met the plan's age and service requirement in fact receive benefits.

A plan demonstrates that it satisfies minimum coverage each year by satisfying either a ratio percentage test or an average benefit test. Governmental plans, whether maintained by a state or local government, or the federal government, are exempt from this requirement and implementing regulations.[3] Salary deferrals to Section 401(k) plans are subject to certain modifications of the coverage requirements (Q 3698).

A plan will not be treated as violating the coverage requirements of Section 410(b) merely on account of the making of, or the right to make, catch-up contributions by participants age fifty or over under the provisions of IRC Section 414(v), so long as a universal availability requirement for access to the catch-up contribution is met (Q 3706).[4]

Ratio Percentage Test

A plan satisfies the ratio percentage test when benefits apply to either 70 percent of all non-highly compensated employees (i.e., the percentage test) or a percentage of the non-highly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan.[5] A participant generally is treated as benefiting if he or she receives an allocation.[6] Individuals are treated as benefiting for deferral purposes if they are eligible to defer, even if they choose not to do so.

Example: Smith Steel Company has a profit sharing plan that allocates a contribution to cover nine of its ten non-excludable highly compensated employees and 160 of its 200 non-excludable non-highly compensated employees. Under its plan, otherwise eligible participants do not receive a contribution unless they are employed at year-end. One of the highly compensated participants and 40 of its non-highly

1. See Rev. Rul. 72-5, 1972-1 CB 106.
2. See Let. Rul. 7742003.
3. IRC Sec. 410(c)(1)(A); See IRC Sec 401(a)(5)(G).
4. IRC Sec. 414(v)(3)(B).
5. IRC Sec. 410(b)(1)(A), (B).
6. Treas. Regs. §1.410(b)-3(a).

compensated terminated and did not receive an allocation. The plan's ratio percentage is determined by dividing the percentage of the non-highly compensated employees who benefit under the plan (160/200, or 80 percent) by the percentage of the highly compensated employees who benefit under the plan (9/10, or 90 percent). Smith Steel's ratio percentage is 80/90, or 89 percent; thus, it passes the 70 percent ratio percentage test.[1]

Average Benefit Test

A plan that cannot satisfy the ratio percentage test still may pass the coverage requirement by satisfying the average benefit test.[2] The average benefits test may allow a plan with a ratio percentage of less than 70 percent to satisfy minimum coverage. It has two parts: the "non-discriminatory classification" test and the "average benefit percentage" test. Both of these requirements must be met for a plan to satisfy the average benefit test.[3] Note that the non-discriminatory classification test has two separate requirements that must be met.

A plan passes the non-discriminatory classification test when the plan benefits "such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated employees."[4] Regulations state that this requirement has two parts: (1) the classification of employees must be reasonable; that is, it must reflect a bona fide business classification of employees,[5] and (2) the classification must be non-discriminatory based on a threshold of coverage specified in regulations. Theoretically it is possible to demonstrate that a classification not satisfying the mathematical threshold of part (2) may satisfy the requirement through a facts and circumstances demonstration or a safe harbor percentage test as explained below.[6]

To determine whether a classification is non-discriminatory, the plan's ratio percentage (as defined above) is compared to a table (described below) that is set forth in the regulations. This table contains a range of "safe harbor" and "unsafe harbor" percentages determined based on the percentage of non-highly compensated employees participating in the plan (a concentration level).[7] This comparison produces one of three results: (1) if the plan's ratio percentage falls below the unsafe harbor percentage, it is discriminatory; (2) if the plan's ratio percentage falls between the safe harbor and unsafe harbor amounts, it must satisfy a facts and circumstances test; or (3) if the plan's ratio percentage falls at or above the safe harbor amount, the classification is non-discriminatory.[8]

The table for the concentration percentage begins with a non-highly compensated employee concentration of zero to 60 percent, and for that level provides a safe harbor percentage of 50 percent and an unsafe harbor percentage of 40 percent. In other words, for an employer with 100 employees, of whom 40 are highly compensated and only 60 are non-highly compensated,

1. See generally Treas. Regs. §1.410(b)-4.
2. IRC Sec. 410(b)(2).
3. Treas. Reg. §1.410(b)-2(b)(3); see IRC Sec. 410(b)(2).
4. IRC Sec. 410(b)(2)(A)(i).
5. Treas. Reg. §1.410(b)-4(b).
6. Treas. Reg. §1.410(b)-4(c).
7. Treas. Reg. §1.410(b)-4(c)(4)(iv).
8. Treas. Reg. §1.410(b)-4(c).

the classification would automatically be non-discriminatory under the safe harbor if its ratio percentage were 50 percent or higher.

Average benefit percentage test. The second part of the average benefit test requires that the average benefit percentage for non-highly compensated employees be at least 70 percent of the average benefit percentage for highly compensated employees.[1] An employee's benefit percentage is the employee's employer-provided contributions, including forfeitures and elective deferrals, or benefits under all qualified plans maintained by the employer, expressed as a percentage of the employee's compensation.[2] Employee contributions and benefits attributable to employee contributions are not taken into account in calculating employee benefit percentages.[3] Regulations permit benefit percentages to be determined on either a contributions or a benefits basis.[4]

The final component of the average benefit test is calculating the average benefit percentage for the plan. This is a separate calculation from the rate group percentages in the previous step. Here, a benefit percentage is calculated for participants taking into account the total of all benefits, including deferrals, employee contributions and forfeiture reallocations, divided by compensation. Then, the average for the non-highly compensated employees is compared to the average of the highly compensated employees. This component is passed only when that ratio is 70 percent or more. All plans of an employer, with certain exceptions, are used in determining the benefit percentages, even if another plan satisfies the ratio percentage test or is a safe harbor design. When an employer maintains separate lines of business or where certain plans for union employees exist, the benefit percentage for any plan year is computed on the basis of contributions or benefits for that year or, at the election of the employer, any consecutive plan year period, up to three years, ending with the plan year and specified in the election. An election under this provision cannot be revoked or modified without the consent of the Secretary of the Treasury.[5]

A plan maintained by an employer that has no employees other than highly compensated employees for any year or that benefits no highly compensated active employees for any year is treated as meeting the minimum coverage requirements.[6]

3763. What are the miscellaneous rules associated with the minimum coverage requirement for qualified plans?

Separate Lines of Business

Employers that operate separate lines of business may apply the tests discussed in Q 3762 separately with respect to employees in each line of business, so long as any such plan benefits

1. IRC Sec. 410(b)(2)(A)(ii); Treas. Reg. §1.410(b)-5(a).
2. IRC Sec. 410(b)(2)(C)(i).
3. Treas. Reg. §1.410(b)-5(d)(2).
4. See Treas. Reg. §1.410(b)-5(d)(5).
5. IRC Sec. 410(b)(2)(C).
6. IRC Sec. 410(b)(6)(F); Treas. Regs. §§1.410(b)-2(b)(5), 1.410(b)-2(b)(6).

a class of employees that is determined, on a company wide basis, not to be discriminatory in favor of highly compensated employees.[1]

A separate line of business exists if the employer, for bona fide business reasons, maintains separate lines of business or operating units. A separate line of business, however, cannot have fewer than fifty employees, disregarding any employees excluded from the top-paid group when determining the employees who are highly compensated (Q 3827). A separate line of business also must meet either a statutory safe harbor with respect to ratios of highly compensated employees provided in the IRC, meet one of the administrative safe harbors provided in final regulations, or request and receive an individual determination from the IRS that the separate line of business satisfies administrative scrutiny.[2]

Former Employees

Active and former employees are tested separately for purposes of the rules.[3] A plan satisfies the coverage requirement with respect to former employees only if, under all the relevant facts and circumstances, the group of former employees' plan does not discriminate significantly in favor of highly compensated former employees.[4]

Excludable Employees

Certain otherwise eligible employees can be excluded from coverage testing. They include employees covered by a collective bargaining agreement, provided that retirement benefits were the subject of good faith bargaining between the employee representatives and the employer, and non-resident aliens who receive no U.S. earned income.[5] Although a plan may permit an otherwise eligible employee to waive his or her right to participate, such a waiver may, under some circumstances, result in discriminatory coverage.[6] Employees who have not satisfied the plan's minimum age and service requirements and are not participants are excluded from consideration in meeting the above tests.[7]

Other employees who meet the plan's age and service requirements may be excluded under the terms of the plan. Such excluded employees include, but are not limited to, employees who, once eligible for the plan, are required to be employed on the last day of the plan year, similar employees who are required to have been credited with at least 1,000 hours in the plan year, and employees who are excluded as a class such as hourly or salaried employees.[8]

1. IRC Sec. 410(b)(5).
2. IRC Sec. 414(r); Treas. Regs. §§1.414(r)-5, 1.414(r)-6.
3. Treas. Reg. §1.410(b)-2(a).
4. Treas. Reg. §1.410(b)-2(c)(2).
5. IRC Sec. 410(b)(3); Treas. Regs. §§1.410(b)-6(d), 1.410(b)-9.
6. See Rev. Rul. 80-351, 1980-2 CB 152. But see *Olmo v. Comm.*, TC Memo 1979-286, Non-acq., 1980 AOD LEXIS 135.
7. IRC Sec. 410(b)(2)(D).
8. Treas. Regs. §1.410(b)-6(b).

Employees Treated as Benefiting

An employee benefits under a plan for a year only if the employee accrues a benefit or receives an allocation under the plan for that year.[1] An employee is treated as "benefiting" under a plan for a plan year if the employee satisfies all of the applicable conditions for accruing a benefit for the year but fails to accrue a benefit solely because of the IRC Section 415 limits or some other uniformly applicable plan benefit limit.[2]

Certain Terminating Employees Excluded from Testing

Many plans require an employee to be employed on the last day of the plan year to be eligible to receive a contribution or benefit. A terminated employee who fails to satisfy the minimum hours of service or a last-day requirement may be excluded from consideration in meeting the coverage test if the employee had accrued no more than 500 hours, terminated service during the plan year, and did not receive a benefit in the plan year.[3]

Mandatory Disaggregation

Some plans or portions of plans must be disaggregated to meet the minimum coverage rules. The mandatory disaggregation requirement specifies that certain single plans must be treated as comprising separate plans, each of which is subject to the minimum coverage requirements.

Some of the plans that generally have to be disaggregated for coverage purposes are:

(1) the portion of a plan that includes a cash or deferred arrangement subject to IRC Section 401(k) (or matching and employee after-tax contributions subject to IRC Section 401(m)), and the portion that does not;

(2) the portion of a plan that is an ESOP, and the portion that is a non-ESOP (this varies from the disaggregation rules that would apply under regulations for ADP/ACP testing purposes only (Q 3731, Q 3732);[4]

(3) the portion of a plan that benefits otherwise excludable employees, and the portion that does not,

(4) a plan that benefits the employees of a separate line of business, and any plan maintained by any other line of business if the employer elects to use the separate line of business rules, and

(5) the portion of a plan that benefits employees under a collective bargaining arrangement, and the portion that benefits non-union employees.[5]

1. Treas. Reg. §1.410(b)-3(a).
2. Treas. Regs. §§1.410(b)-3(a)(2)(ii), 1.410(b)-3(a)(2)(iii).
3. Treas. Reg. 1.410(b)-6(f).
4. See Treas. Reg. §1.401(k)-1(b)(4)(v).
5. Treas. Reg. §1.410(b)-7(c)(4).

For testing the benefits of employees who change from one qualified separate line of business to another, a reasonable treatment must be used.[1] A multiple employer plan (a plan covering two or more unrelated employers) also is treated as comprising separate plans each of which is maintained by a separate employer and generally must satisfy the minimum coverage requirements by reference only to such employer's employees.[2]

Permissive Aggregation

For purposes of applying the ratio percentage test and the non-discriminatory classification test, an employer may elect to designate two or more of its plans as a single plan, but only if the plans have the same plan years.[3] If plans are aggregated under this rule, they must be treated as a single plan for all purposes under IRC Sections 410(b) and 401(a)(4).[4]

Of course, plans that are required to be disaggregated under the rules described above cannot be aggregated under this rule. Furthermore, for purposes of applying these tests, the following plans also must be disaggregated: the portion of a plan that is an ESOP, and the portion that is a non-ESOP; and the portion of a plan that includes a cash or deferred arrangement subject to IRC Section 401(k) (or matching and employee after-tax contributions subject to IRC Section 401(m)), and the portion that does not.[5]

For purposes of applying the average benefit percentage test, all plans that may be aggregated under the permissive aggregation rules must be aggregated and treated as a single plan. In addition, plans (or portions of plans) that are ESOPs or that are subject to IRC Section 401(k) or 401(m) also must be aggregated with all other qualified plans of the employer.[6]

A special rule in the final regulations permits benefits provided to collectively bargained employees and non-collectively bargained employees to be considered together, for purposes of the average benefit percentage test only, if certain requirements are met.[7]

Snapshot Testing

The IRC states that a plan will be considered as meeting the minimum coverage requirement during the whole of any taxable year of the plan if on one day in each quarter it satisfied that requirement.[8] Employers may demonstrate compliance with the coverage requirement using "snapshot" testing on a single day during the plan year, provided that that day is representative of the employer's work force and the plan's coverage throughout the plan year.[9]

1. Treas. Reg. §1.410(b)-7(c)(4)(i)(D).
2. Treas. Reg. §1.410(b)-7(c)(4)(ii)(C).
3. Treas. Regs. §§1.410(b)-7(d)(1), 1.410(b)-7(d)(5).
4. Treas. Reg. §1.410(b)-7(d).
5. Treas. Regs. §§1.410(b)-7(c), 1.410(b)-7(d)(2).
6. IRC Sec. 401(k)(4)(C); Treas. Reg. §1.410(b)-7(e).
7. See Treas. Reg. §1.410(b)-5(f).
8. IRC Sec. 401(a)(6).
9. Rev. Proc. 93-42, 1993-2 CB 540, *modified by* Rev. Proc. 95-34, 1995-2 CB 385.

Corrective Amendments

A plan that does not satisfy the minimum coverage requirement during a plan year may be retroactively amended by the fifteenth day of the tenth month after the close of the plan year to satisfy one of the tests.[1] This amendment would have the effect of including individuals who had been excluded by the plan. A retroactive amendment must separately satisfy the non-discrimination and minimum coverage requirements, and cannot violate the anti-cutback rule of IRC Section 411(d)(6) (Q 3777, Q 3786).[2]

Merger or Acquisition

The IRC provides certain transition relief from the coverage rules in the event of a merger or acquisition.[3] The IRS has provided guidance for certain changes in a plan sponsors' controlled group, offering temporary relief from the coverage requirements provided that each plan has satisfied the coverage requirements prior to the change in the controlled group and no significant change in the plan or its coverage takes place during the transition period, other than the change resulting from the merger or acquisition itself.[4]

Effect of Non-Compliance

Special rules apply to prevent a loss of tax qualification when a plan fails to qualify solely because it does not meet one of the coverage tests. In this case, contributions on behalf of non-highly compensated employees will not be taxed under the rules for non-qualified plans. (Presumably, all other complications arising from plan disqualification would apply.) Instead, highly compensated employees will be required to include in income the amount of their vested accrued benefits, other than their investment in the contract.[5]

The minimum coverage requirement generally is inapplicable to church plans and governmental plans are treated as meeting the coverage provisions.[6] The coverage regulations generally apply to tax-exempt organizations; however, non-contributory plans maintained by certain tax-exempt organizations (i.e., a society, order, or association described in IRC Sections 501(c)(8) or 501(c)(9)) are not subject to the coverage requirements.[7]

Plan for Sole Shareholder

A corporation may have a qualified plan even though it has only one permanent employee and that employee owns all the stock of the corporation. If the plan is either designed or operated so that only the shareholder-employee can ever benefit, however, it will not qualify. Provision must be made for participation of future employees if any are hired.[8]

1. Treas. Regs. §§1.401(a)(4)-11(g)(2), 1.401(a)(4)-11(g)(3)(iv).
2. Treas. Reg. §1.401(a)(4)-11(g)(3).
3. See IRC Sec. 410(b)(6)(C).
4. For details, see Rev. Rul. 2004-11, 2004-7 IRB 480.
5. IRC Sec. 402(b)(2).
6. See IRC Secs. 410(c)(1)(B), 410(c)(2).
7. IRC Sec. 410(c)(1)(D).
8. Rev. Rul. 63-108, 1963-1 CB 87; Rev. Rul. 55-81, 1955-1 CB 392.

A pension plan will not fail to qualify merely because it is established by a corporation that is operated for the purpose of selling the services, abilities, or talents of its only employee, who is also its principal or sole shareholder.[1] The plan of a corporation's sole shareholder was disqualified for violating the coverage requirement after it was shown that the only two hired personnel of the company, who had been excluded from the plan as independent contractors, in fact were employees.[2]

As to which individuals must be treated as employees and what organizations make up an employer, see Q 3825, Q 3826, Q 3830, and Q 3832.

Nondiscrimination

3764. When is a plan nondiscriminatory?

The IRC has established requirements that prohibit a plan from providing benefits that discriminate in favor of highly compensated employees. A plan will demonstrate that it is not discriminatory by passing certain annual nondiscrimination testing under IRC Section 401(a)(4) or through using a plan that has a safe harbor design. A plan demonstrates that it is not discriminatory in favor of highly compensated employees by satisfying, on an annual basis, three basic requirements:

(1) contributions or benefits must not discriminate in favor of "highly compensated employees" as defined in IRC Section 414(q) (Q 3827); the annual testing to meet this requirement is described in Q 3766;

(2) benefits, rights, and features available to employees are not discriminatory in favor of highly compensated employees (Q 3776); and

(3) the effect of plan amendments, including grants of past service credit, and plan terminations cannot be discriminatory in favor of highly compensated employees (Q 3777).[3]

Employees not included in the plan but who are covered by a collective bargaining agreement can be excluded from consideration in meeting the nondiscrimination requirement if there is evidence that retirement benefits were the subject of good faith bargaining between the employee representatives and the employer. If union employees are covered under the plan, benefits or contributions must be provided for them on a nondiscriminatory basis.[4] Nonresident aliens with no U.S. earned income also may be excluded.

Governmental plans generally are not subject to the requirements of IRC Section 401(a)(4).[5]

1. Rev. Rul. 72-4, 1972-1 CB 105 (Rev. Rul. 55-81 amplified).
2. See *Kenney v. Comm.*, TC Memo 1995-431.
3. Treas. Reg. §1.401(a)(4)-1(b)(1).
4. IRC Secs. 401(a)(4), 410(b)(3). See, e.g., Let. Rul. 8419001.
5. See IRC Sec. 401(a)(5)(G).

Regulations under IRC Section 401(a)(4) provide the exclusive rules for determining whether a plan satisfies the nondiscrimination requirements of IRC Section 401(a)(4).[1] A plan may satisfy the nondiscrimination requirement on the basis of either measuring the employer's contributions or the benefits attributable to those contributions (benefits testing). Both options are available regardless of whether the plan is a defined benefit plan or a defined contribution plan. The process of testing defined benefit plans on the basis of contributions or defined contribution plans on the basis of benefits is referred to as "cross testing" (Q 3778).

A plan will not be considered discriminatory merely because contributions or benefits bear a uniform relationship to the employees' compensation (Q 3783).[2] A plan will satisfy IRC Section 401(a)(4) only if it complies both in form and in actual operation with the regulations that provide for nondiscrimination testing methods and safe harbor designs. Intent is irrelevant in making this determination.[3]

A plan also will not be treated as discriminatory merely on account of the making of, or the right to make, catch-up contributions (Q 3706) by participants age fifty or over under the provisions of IRC Section 414(v), so long as a universal availability requirement is met.[4]

There are two basic options for satisfying the IRC's nondiscrimination requirements. The plan can use one of the safe harbor formulas stated in the regulations or it can satisfy certain testing annually. Thus, plans that do not meet the requirements for one of the safe harbors must use the general nondiscrimination test. The safe harbor compliance methods are design-based; essentially, they require the plan to have uniform provisions that reduce the potential for prohibited discrimination and therefore, annual testing, is unnecessary. As a result, the safe harbors avoid costly testing, which focuses on actual plan results and requires annual review

Planning Point: Employers typically shun the safe harbor method and opt to structure plans that favor owners and higher paid employees.

3765. What safe harbor designs allow a defined contribution plan to satisfy the nondiscrimination requirements?

The regulations set forth two safe harbor designs for defined contribution plans.

Under the first safe harbor, referred to as a uniform allocation formula, a defined contribution plan will be nondiscriminatory if it allocates employer contributions and forfeitures for the year under an allocation formula that allocates to each employee the same percentage of plan year compensation, the same dollar amount, or the same dollar amount for each uniform unit of service (not exceeding one week) performed by the employee during the year.[5]

1. Treas. Reg. §1.401(a)(4)-1(a).
2. IRC Sec. 401(a)(5)(B).
3. Treas. Reg. §1.401(a)(4)-1(a).
4. IRC Sec. 414(v)(3)(B).
5. Treas. Reg. §1.401(a)(4)-2(b)(2).

The second safe harbor design is referred to as a uniform points allocation formula. This formula allows a defined contribution plan other than an ESOP to be nondiscriminatory even though contributions are weighted for age, service, or compensation.[1] It unfortunately imposes restrictions that limit its ability to favor higher paid employees with larger contributions and for that reason is seldom found outside the not-for-profit world.

A plan with a non-uniform allocation formula may retain its safe harbor status if the effect of the non-uniform allocation is to provide lower benefits to highly compensated employees.[2]

3766. How can a defined contribution plan that does not satisfy one of the safe harbor designs show that it does not discriminate in favor of highly compensated employees?

A defined contribution plan other than plans subject to IRC Section 401(k) or 401(m) that does not satisfy one of the safe harbor designs will meet the "nondiscrimination in amount" requirement if it meets a general test. First, the employer calculates a benefit percentage ratio for each employee and sets up rate groups based upon these benefit percentages.

The next step is to compare the rate groups for highly compensated employees to the rate groups for non-highly compensated employees. It is such a complicated process that this discussion is just an overview of the process. If each "rate group" satisfies the minimum coverage requirements of IRC Section 410(b), the plan will have passed the general test. For this purpose, a "rate group" exists for each highly compensated employee in the plan, and consists of highly compensated employees ("HCEs") and all other employees in the plan (whether highly compensated or non-highly compensated) who have an allocation rate greater than or equal to the highly compensated employee's allocation rate. In other words, each employee, regardless of compensation level, is in the rate group for every HCE who has an allocation rate less than or equal to that employee's allocation rate.[3]

3767. What safe harbors exist that allow a defined benefit plan to satisfy the nondiscrimination requirements?

The final regulations provide a set of uniformity requirements that apply to all defined benefit safe harbors. A plan generally must provide a uniform normal retirement benefit in the same form for all employees, using a uniform normal retirement age. For purposes of this requirement, Social Security retirement age will be treated as a uniform retirement age.[4] The regulations provide for three safe harbors: one for unit credit plans, one for fractional accrual plans (including flat benefit plans), and one for insurance contract plans.[5]

1. See Treas. Reg. §1.401(a)(4)-2(b)(3).
2. Treas. Reg. §1.401(a)(4)-2(b)(4)(v).
3. Treas. Reg. §1.401(a)(4)-2(c)(1).
4. IRC Sec. 401(a)(5)(F).
5. Treas. Reg. §1.401(a)(4)-3(b).

3768. How can a defined benefit plan that does not satisfy one of the safe harbors show that it does not discriminate in favor of highly compensated employees?

Defined benefit plans that do not satisfy any of the safe harbors will satisfy the "nondiscriminatory in amount" requirement only if they satisfy the general test, which requires the calculation of accrual rates and an analysis of their distribution. The general test will be satisfied if each "rate group" satisfies the minimum coverage requirements of IRC Section 410(b). For this purpose, a "rate group" exists for each highly compensated employee in the plan, and consists of the highly compensated employee and all other employees in the plan (whether highly compensated or non-highly compensated) who have a normal accrual rate greater than or equal to the highly compensated employee's normal accrual rate, *and* who also have a most valuable accrual rate greater than or equal to the highly compensated employee's most valuable accrual rate.

Planning Point: In other words, an employee is in the rate group for each highly compensated employee who has a normal accrual rate less than or equal to the employee's normal accrual rate and who also has a most valuable accrual rate less than or equal to the employee's most valuable accrual rate.[1]

The regulations provide a facts and circumstances "safety valve" for certain defined benefit plans that would pass the general test if no more than 5 percent of the highly compensated employees were disregarded. If the IRS determines on the basis of all the relevant facts and circumstances that such a plan does not discriminate with respect to the amount of employer-provided benefits, the plan will pass the general test. For purposes of calculating the 5 percent, the number of highly compensated employees may be rounded to the nearest whole number.[2]

3769. Can a plan satisfy the nondiscrimination requirements by limiting participation to highly compensated employees and nonhighly compensated employees with very short periods of service?

The IRS released guidance expressing disapproval of plans that attempt to satisfy the nondiscrimination requirements by limiting participation to highly compensated employees and to rank and file employees with very short periods of service. The IRS noted that sponsors of such plans use "plan designs and hiring practices that limit who receives a benefit to the nonhighly compensated employees and to other employees with very small amounts of compensation" and whose tenure with the company never results in their benefits being vested. These plans are targeted for adverse rulings, possible disqualification, or other actions.[3]

3770. What safe harbor designs allow a target benefit plan to satisfy the nondiscrimination requirements?

The regulations provide a safe harbor testing method for target benefit plans. Because target benefit plans are defined contribution plans that determine allocations based on a defined benefit funding approach, the safe harbor is included in the rules for cross testing.

1. Treas. Reg. §1.401(a)(4)-3(c)(1).
2. Treas. Reg. §1.401(a)(4)-3(c)(3).
3. Memorandum dated October 22, 2004, Carol D. Gold, Director Employee Plans.

A target benefit plan generally will be deemed to meet the "nondiscrimination in amount" requirement if:

(1) it satisfies uniformity requirements with respect to normal retirement age and the allocation formula (the Social Security retirement age will be treated as a uniform retirement age);[1]

(2) it provides a stated benefit formula that complies with one of the defined benefit plan safe harbors that uses the fractional accrual rule;

(3) employer contributions are determined under an individual level premium funding method specified in the regulations, based on an employee's stated benefit and "theoretical reserve;"

(4) employee contributions, if any, are not used to fund the stated benefit; and

(5) the stated benefit formula satisfies Treasury Regulation Section 1.401(l)-3, if permitted disparity is taken into account.[2]

3771. How do 401(k) plans satisfy the IRC nondiscrimination requirements?

These plans may not use the general test of IRC Section 401(a)(4). The plans must satisfy the IRC's nondiscrimination requirements following the requirements that are specified under IRC Sections 401(k) and 401(m). Those sections also allow several safe harbor designs that can eliminate a requirement to complete a mathematical test for deferrals and matching contributions (Q 3731 to Q 3733).[3]

3772. Can a plan satisfy the IRC nondiscrimination requirements through aggregating multiple plans or restructuring the plan?

Under certain circumstances, a plan may be aggregated or combined with other plans or restructured (i.e., treated as two or more separate plans) for purposes of meeting the nondiscrimination in amount requirement. Where plans are restructured, each component plan must separately satisfy the nondiscrimination requirements and the coverage requirements (Q 3762).[4]

If two or more plans are permissively aggregated and treated as a single plan for purposes of satisfying the minimum coverage requirements (Q 3762), the aggregated plans also must be treated as a single plan for purposes of meeting the nondiscrimination requirements.[5] The regulations include guidelines for determining whether several of these plans, when considered as a unit, provide contributions and benefits that discriminate in favor of highly compensated employees.

1. IRC Sec. 401(a)(5)(F).
2. Treas. Reg. §1.401(a)(4)-8(b)(3).
3. IRC Secs. 401(k), 401(m); Treas. Reg. §1.401(a)(4)-1(b)(2)(ii)(B).
4. See Treas. Reg. §1.401(a)(4)-9(c).
5. Treas. Reg. §1.401(a)(4)-9(a).

A disability plan that is not a pension, profit sharing, stock bonus, or annuity plan may not be aggregated with these plans for this purpose.[1]

Special rules are provided for applying the nondiscrimination requirements to an aggregated plan that includes both a defined benefit plan and a defined contribution plan.[2] Special rules apply where an aggregated plan includes a new comparability plan (Q 3778).[3]

3773. Will a plan be considered discriminatory if it is integrated with Social Security?

An integrated plan will not be considered discriminatory merely because the plan is integrated with Social Security (i.e., the plan uses the permitted disparity rules).[4] As a result, if a plan is integrated in a way that satisfies the permitted disparity rules, the disparity is disregarded in determining whether the plan satisfies the applicable defined contribution or defined benefit safe harbor.[5] For details on Social Security integration, see Q 3779.

3774. What substantiation requirements must an employer follow to show compliance with the IRC nondiscrimination requirement?

Employers may demonstrate compliance with the "nondiscrimination in amount" requirement by using "snapshot" testing on a single day during the plan year, provided that that day is representative of the employer's work force and the plan's coverage throughout the plan year.[6]

3775. Is a plan that offers credits for past service considered discriminatory?

The effect of plan provisions with respect to grants of past service must be non-discriminatory. The determination of whether credit for past service causes discrimination is made on a facts and circumstances basis. A plan provision that credits pre-participation service or imputed service to any highly compensated employee will be considered non-discriminatory if, based on all the facts and circumstances, the provision applies on the same terms to all similarly-situated non-highly compensated employees, there is a legitimate business purpose for crediting the service, and the crediting of the service does not discriminate significantly in favor of highly compensated employees.[7] For an explanation of the nondiscrimination requirements for plan amendments granting past service credit, see Q 3777.

As to which individuals must be treated as employees and what organizations constitute the employer in the IRC's nondiscrimination testing, see Q 3825, Q 3826, Q 3830, and Q 3832.

1. See Rev. Rul. 81-33, 1981-1 CB 173.
2. See Treas. Reg. §1.401(a)(4)-9(b).
3. See Treas. Reg. §1.401(a)(4)-9(c)(3)(ii).
4. See IRC Sec. 401(a)(5)(D).
5. See Treas. Reg. §1.401(l)-1(a)(1).
6. Rev. Proc. 93-42, 1993-2 CB 540, modified by Rev. Proc. 95-34, 1995-2 CB 385.
7. Treas. Reg. §1.401(a)(4)-11(d)(3)(iii).

3776. What are the requirements with respect to the nondiscriminatory availability of plan benefits, rights, and features?

The benefits, rights, and features provided under a plan (i.e., all optional forms of benefit, ancillary benefits, and other rights and features available to any employee under a plan) must be made available in a nondiscriminatory manner. Benefits, rights, and features generally will meet this requirement only if each benefit, right, and feature satisfies a "current availability" requirement and an "effective availability" requirement.[1]

The current availability requirement generally is satisfied if the group of employees to whom the benefit, right, or feature is currently available during the plan year satisfies the minimum coverage test (Q 3762) without regard to the average benefit percentage test.[2]

Current availability is based on the current facts and circumstances of the employee; the fact that an employee may satisfy an eligibility condition in the future does not make the benefit option currently available to that employee. Conditions based on termination of employment, disability, hardship, or conditions based on age or length of service may be disregarded in determining current availability.[3]

To satisfy the effective availability requirement, the group of employees to whom a benefit, right, or feature is effectively available must not substantially favor highly compensated employees, based on all the facts and circumstances.[4] Thus, for example, a matching contribution that is available only to employees deferring a relatively high percentage of income would fail this requirement if the level of deferral required makes the match effectively unavailable to most non-highly compensated employees.

A plan that offers catch-up contributions will not be treated as violating these requirements merely because participants age fifty or over make, or have the right to make, catch-up contributions under the provisions of IRC Section 414(v), so long as a universal availability requirement is met (Q 3706).[5]

The IRS has issued guidance under which two optional forms of benefit that differ only with respect to the timing of their commencement generally may be aggregated and treated as a single optional form of benefit for purposes of satisfying the nondiscriminatory current and effective availability requirements.[6] For example, a preretirement age 70½ distribution option that is available only to 5 percent owners, as required under IRC Section 401(a)(9) (Q 3803), may be aggregated with another optional form of benefit that differs only in the timing of the commencement of payments, provided certain requirements are met.[7]

1. Treas. Regs. §§1.401(a)(4)-1(b)(3), 1.401(a)(4)-4(a).
2. Treas. Reg. §1.401(a)(4)-4(b)(1).
3. Treas. Reg. §1.401(a)(4)-4(b)(2).
4. Treas. Reg. §1.401(a)(4)-4(c)(1).
5. IRC Sec. 414(v)(3)(B).
6. See Notice 97-75, 1997-2 CB 337.
7. Notice 97-75, 1997-2 CB 337, A-5.

The fact that subsidized early retirement benefits and joint and survivor annuities are based on an employee's Social Security retirement age generally will not result in their being treated as unavailable to employees on the same terms.[1]

Employers may demonstrate compliance with the current availability requirement by using snapshot testing on a single day during the plan year, provided that that day is representative of the employer's work force and the plan's coverage throughout the plan year.[2]

The IRS determined that a plan, in operation, violated IRC Section 401(a)(4) when it permitted highly compensated employees to direct their own investments, which resulted in their earning a substantially higher return than that earned on contributions by rank and file employees. The IRS commented that even if the investment decisions had resulted in a lower return or a loss, the opportunity for only highly compensated employees to make their own investment decisions still would result in discrimination.[3]

3778. What nondiscrimination requirements must a plan meet with respect to plan amendments and terminations?

The timing of plan amendments must not have the effect of discriminating significantly in favor of highly compensated employees.[4] For this purpose, a plan amendment includes the establishment or termination of the plan, as well as any change in the benefits, rights, or features, benefit formulas, or allocation formulas under the plan.[5]

Regulations provide a facts and circumstances test for determining whether a plan amendment or series of amendments has the effect of discriminating significantly in favor of current or former highly compensated employees.[6]

The timing of a plan amendment that grants past service credit or increases benefits attributable to years of service for a period in the past will be deemed to be nondiscriminatory if the following four safe harbor requirements are met:

(1) the period for which the credit is granted does not exceed the five years preceding the current year,

(2) the past service credit is granted on a reasonably uniform basis to all employees,

(3) benefits attributable to the period are determined by applying the current plan formula, and

(4) the service credited is service, including pre-participation or imputed service (Q 3764), with the employer or a previous employer.[7]

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1. IRC Sec. 401(a)(5)(F)(ii).
2. Rev. Proc. 93-42, 1993-2 CB 540.
3. TAM 9137001.
4. Treas. Reg. §1.401(a)(4)-1(b)(4).
5. Treas. Reg. §1.401(a)(4)-5(a).
6. Treas. Reg. §1.401(a)(4)-5(a)(2).
7. Treas. Reg. §1.401(a)(4)-5(a)(3).

Guidelines for nondiscriminatory allocation of assets on termination of a defined benefit plan are set forth in Revenue Ruling 80-229.[1]

3778. What are the requirements for cross tested plans?

Cross testing is the process by which defined contribution plans are tested for prohibited nondiscrimination on the basis of benefits and defined benefit plans are tested on the basis of contributions. The general rules for converting allocations under a defined contribution plan to equal benefits and for converting benefits under a defined benefit plan to equal allocation rates are explained at Treasury Regulation Section 1.401(a)(4)-8.

The most common form of cross testing is new comparability testing of profit sharing plans. That is because it is normally more advantageous for older and more highly compensated participants to have contributions to a defined contribution plan tested on the basis of equivalent benefits than it is to have benefits in a defined benefit plan tested on the basis of allocations. The new comparability feature uses cross testing to show that contributions under a plan provide nondiscriminatory benefits. Cross testing also can involve aggregating a defined benefit plan with a defined contribution plan, and testing plans together on the basis of the benefits they provide.

Cross-testing requires that a plan pass two tests: the gateway test and the non-discrimination test.

The Gateway Test

The gateway test requires that even a cross-tested plan must provide a minimum level of benefits to all participants and is a precondition to moving on to the nondiscrimination test.

The minimum allocation gateway test sets forth two standards for new comparability plans. First, if the allocation rate for each non-highly compensated employee ("NHCE") in the plan is at least one-third of the allocation rate of the highly compensated employee ("HCE") with the highest allocation rate under the plan, the gateway will be satisfied. In the alternative, if the allocation rate for each NHCE is at least 5 percent of his or her plan year compensation, within the meaning of IRC Section 415(c)(3) (Q 3783), the gateway will be satisfied.[2]

In lieu of the gateway contribution test, a new comparability plan may pass through the gateway if it provides for "broadly available allocation rates." To be broadly available, each allocation rate must be available to a group of employees that satisfies IRC Section 410(b), without regard to the average benefit percentage test (Q 3762).[3] Final regulations liberalized this determination somewhat by allowing groups receiving two different allocation rates to be aggregated for purposes of determining whether allocation rates are "broadly available." Thus, for example, a group receiving a 3 percent allocation rate could be aggregated with a group receiving a 10 percent allocation rate if each group passes the coverage test (not counting the

1. 1980-2 CB 133.
2. Treas. Reg. §1.401(a)(4)-8(b)(1)(vi)(A).
3. Treas. Reg. §1.401(a)(4)-8(b)(1)(iii)(A).

average benefit percentage test).[1] Differences in allocation rates resulting from permitted disparity under the Section 1.401(l) regulations may be disregarded.[2]

A plan that provides for age-based allocation rates also will be excepted from the minimum allocation gateway if it has a gradual age or service schedule. A plan has a gradual age or service schedule if the allocation formula for all employees under the plan provides for a single schedule of allocation rates that (1) defines a series of bands based solely on age, years of service, or points representing the sum of the two that applies to all employees whose age, years of service, or points are within each band, and (2) the allocation rates under the schedule increase smoothly at regular intervals (as defined in the regulations).

Sample schedules of smoothly-increasing allocation schedules, based on the sum of age and service, are included in the final regulations.[3] Certain plans that fail the safe harbor for target benefit plans[4] may satisfy the requirements for age-based allocation rates if the plan's allocation rates are based on a uniform target benefit allocation.[5]

The Nondiscrimination Test

Once the gateway test is passed, the equivalent benefit rate groups are subject to nondiscrimination testing. To pass nondiscrimination testing, every rate group must satisfy the coverage requirements of IRC Section 410(b) (Q 3776). Both the ratio percentage test and average benefit test are available for this purpose.

A defined benefit plan, benefitting primarily HCEs, may be aggregated with a defined contribution plan benefitting primarily NHCEs if a gateway similar to the one described above is met, with the 5 percent safe harbor contribution being increased to 7.5 percent.[6]

In the alternative, if the combined plan is primarily defined benefit in character or consists of broadly available separate plans, as defined in regulations, it may be nondiscriminatory without satisfying the gateway.[7]

The IRS released guidance expressing disapproval with plans that attempt to satisfy the nondiscrimination requirements by limiting participation to highly compensated employees and to rank and file employees with very short periods of service. By way of example, the IRS stated that a plan cross tested under the forgoing provisions violates the nondiscrimination requirements of IRC Section 401(a)(4) (Q 3764) where:

(1) the plan excludes most or all permanent NHCEs,

(2) the plan covers a group of NHCEs who were hired temporarily for short periods of time,

1. Rev. Rul. 2001-30, 2001-1 CB 46.
2. Treas. Reg. §1.401(a)(4)-8(b)(1)(vii).
3. Treas. Reg. §1.401(a)(4)-8(b)(1)(iv)(A).
4. See Treas. Reg. §1.401(a)(4)-8(b)(3).
5. See Treas. Reg. §1.401(a)(4)-8(b)(1)(v).
6. Treas. Reg. §1.401(a)(4)-9(b)(2)(v)(A) and (D).
7. See Treas. Reg. §1.401(a)(4)-9(b)(1)(v)(B) and (C).

(3) the plan allocates a higher percentage of compensation to the accounts of the HCEs than to those of the NHCEs covered by the plan, and

(4) compensation earned by the NHCEs covered by the plan is significantly less than the compensation earned by the NHCEs not covered by the plan.[1]

3779. What is permitted disparity and how does it work?

Permitted disparity, which also is called Social Security integration, describes a contribution allocation formula or a benefit accrual formula that has two tiers of benefits. Under this formula, higher paid participants receive a slightly larger employer-provided benefit than employees whose contribution is below a level specified in the plan (i.e., the integration level in a defined contribution plan).

Permitted disparity rules are an exception to the general nondiscrimination requirement. Thus, a plan may use permitted disparity and still be classified as a safe-harbor design. The two-tier formula is based on the principle that employer-paid Social Security benefits will fund a greater portion of the replacement income of lower paid workers than of those whose earnings are above the Social Security wage base. The rules for permitted disparity are found under IRC Section 401(l).

An integrated plan will not be considered discriminatory merely because plan contributions or benefits favor the highly compensated employees if certain disparity thresholds are met.[2] If the requirements of IRC Section 401(l) are met, the disparity will be disregarded in determining whether the plan satisfies the nondiscrimination rules (Q 3764).[3] The regulations under IRC Section 401(l) provide the exclusive means for a plan to satisfy IRC Sections 401(l) and 401(a)(5)(C).[4]

Disparity formulas are not permitted for ESOPs, salary deferrals under a 401(k) plan, or employee or matching contributions to a 401(m) plan (Q 3698 to Q 3730).

3780. What are the permitted disparity requirements applicable to defined contribution plans?

A defined contribution plan may provide for disparity in the rates of employer contributions allocated to employees' accounts if the contribution allocation formula meets the following requirements:

(1) The disparity between contributions above the integration level (and contributions below the integration level)[5] must not exceed the maximum excess allowance. The maximum excess allowance is the lesser of (1) the base contribution percentage, or (2) the greater of (x) 5.7 percentage points or (y) the percentage equal to

1. Memorandum dated October 22, 2004, Carol D. Gold, Director Employee Plans.
2. IRC Sec. 401(a)(5)(C).
3. Treas. Reg. §1.401(l)-1(a)(1).
4. Treas. Reg. §1.401(l)-1(a)(3).
5. Treas. Regs. §§1.401(l)-2(a)(2), 1.401(l)-1(c)(16)(ii).

the portion of the rate of Social Security tax in effect for the year that is attributable to old-age insurance.[1] When the integration level in the plan document is less than the Social Security wage base, the percentages reflected above will need to be reduced as specified in regulations. The IRS will publish the percentage rate of the portion attributable to old-age insurance when it exceeds 5.7 percent.[2]

(2) The integration level, which determines the two levels of contributions, can be either equal to the taxable wage base in effect as of the beginning of the plan year, or a lower amount. If lower, then the contribution percentages must be reduced to satisfy one of two alternative tests.[3] The integration level is the amount of compensation specified under the plan at or below which the rate of contributions, expressed as a percentage, is less than the rate of contribution above that level.[4]

Special rules apply to target benefit plans (Q 3764).[5] Cash balance plans (Q 3669) that meet the safe harbor requirements provided in final regulations under IRC Section 401(a)(4) may satisfy the permitted disparity rules on the basis of the defined contribution plan rules.[6]

3781. What are the permitted disparity requirements applicable to defined benefit plans?

A defined benefit plan may be structured to use permitted disparity and satisfy the safe harbor of Treasury regulations under IRC Section 401(a)(4). A defined benefit plan will not be considered discriminatory merely because the plan provides that a participant's retirement benefit may not exceed the excess of (1) the participant's final pay with the employer, over (2) the retirement benefit, under Social Security law, derived from employer contributions attributable to service by the participant with the employer.[7] The participant's final pay is the highest compensation paid to the participant by the employer for any year that ends during the five year period ending with the year in which the participant separated from service.[8] Compensation in excess of $260,000 (in 2014, up from $255,000 in 2013) may not be taken into account.[9]

A defined benefit plan may provide for disparity in the rates of employer-provided benefits if it meets all of the following requirements:

(1) The disparity in benefit accruals for all employees under the plan must not exceed the maximum excess allowance (in the case of an excess plan) or the maximum offset allowance (in the case of an offset plan).[10]

1. IRC Sec. 401(l)(2).
2. Treas. Regs. §§1.401(l)-2(a)(3), 1.401(l)-2(b).
3. Treas. Regs. §§1.401(l)-2(a)(5), 1.401(l)-2(d).
4. IRC Sec. 401(l)(5)(A).
5. See Treas. Reg. §1.401(a)(4)-8(b)(3)(i)(C).
6. Treas. Reg. §1.401(a)(4)-8(c)(3)(iii)(B).
7. IRC Sec. 401(a)(5)(D)(i); Treas. Reg. §1.401(a)(5)-1(d)(2).
8. IRC Sec. 401(a)(5)(D)(ii).
9. Treas. Reg. §1.401(a)(5)-1(e)(2); IRC Sec. 401(a)(17); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
10. Treas. Regs. §§1.401(l)-3(a)(3), 1.401(l)-3(b)(1).

The maximum excess allowance is the lesser of .75 percent (subject to reduction as described below) or the base benefit percentage for the plan year.[1] The maximum excess allowance cannot exceed the base benefit percentage.[2]

The maximum offset allowance is the lesser of (1) .75 percent (reduced as described below) or (2) one-half of the gross benefit percentage multiplied by a fraction (not to exceed one) of which the numerator is the employee's average annual compensation and the denominator is the employee's final average compensation up to the offset level.[3] The maximum offset allowance may not exceed 50 percent of the benefit that otherwise would have accrued.[4] For plans meeting the maximum offset allowance limitation, the "PIA Offset" safe harbor described below may be available.

(2) The disparity for all employees under the plan must be uniform.[5] To be uniform, an excess plan must use the same base benefit percentage and the same excess benefit percentage for all employees with the same number of years of service. An offset plan is uniform only if it uses the same gross benefit percentage and the same offset percentage for all employees with the same number of years of service. The disparity provided under a plan that determines each employee's accrued benefit under the fractional accrual method in IRC Section 411(b)(1)(C) is subject to special uniformity requirements.[6]

(3) The integration level under an excess plan or the offset level under an offset plan for each participant must be the participant's "covered compensation" (see below), a uniform percentage above 100 percent of covered compensation, a uniform dollar amount, or one of two intermediate amounts specified in the regulations.[7]

Regulations under IRC Sections 401(a)(4) and 401(l) provide a "PIA offset" safe harbor for those defined benefit plans that limit the offset to the maximum offset allowance described above. Under the safe harbor, a defined benefit plan that satisfies any of the existing safe harbors provided in the regulations under IRC Section 401(a)(4) will not fail to be a safe harbor plan merely because it offsets benefits by a percentage of PIA.[8]

Covered compensation, which is similar to the integration level in defined contribution plans and only applies to permitted disparity in defined benefit plans, means the average of the taxable wage bases for the thirty-five calendar years ending with the last day of the calendar

1. Treas. Reg. §1.401(l)-3(b)(2).
2. IRC Sec. 401(l)(4)(A).
3. Treas. Reg. §1.401(l)-3(b)(3).
4. IRC Sec. 401(l)(4)(B).
5. Treas. Reg. §1.401(1)-3(b)(1).
6. Treas. Regs. §§1.401(l)-3(a)(4), 1.401(l)-3(c)(1).
7. Treas. Reg. §1.401(l)-3(d). See IRC Sec. 401(l)(5)(A).
8. Treas. Reg. §1.401(l)-3(c)(2)(ix).

year an individual attains Social Security retirement age.[1] The IRS publishes tables annually for determining employees' covered compensation.[2]

Average annual compensation is the participant's highest average annual compensation for any period of at least three consecutive years or, if shorter, the participant's full period of service.[3]

Final annual compensation is the participant's average annual compensation for the three consecutive year period ending with the current year, or, if shorter, the participant's full period of service, but not exceeding the contribution and benefit base in effect for Social Security purposes for the year.[4]

Final regulations require certain reductions in the .75 percent factor if the integration or offset level exceeds covered compensation or if benefits begin at an age other than Social Security retirement age. These reductions may be determined on an individual basis by comparing each employee's final average compensation to the employee's covered compensation.[5]

3782. What are the permitted disparity requirements when an employee is covered by two or more plans of any employer?

The IRC specifies that in the case of an employee covered by two or more plans of an employer, regulations are to provide rules preventing the multiple use of the disparity otherwise permitted under IRC Section 401(l). Consequently, final regulations provide both an annual overall limit and a cumulative overall limit.[6]

The annual overall permitted disparity limit requires the determination of a fraction based on the disparity provided to an employee for the plan year under each plan. The annual overall limit is met if the sum of those fractions does not exceed one.[7]

The cumulative permitted disparity limit generally is satisfied if the total of an employee's annual disparity fractions under all plans for all years of service does not exceed 35.[8]

3783. What is compensation for purposes of nondiscrimination in a qualified plan?

Compensation applies in at least three different ways under the IRC when addressing nondiscrimination requirements for qualified plans.

First, when plans are tested for prohibited discrimination in favor of highly compensated employees, one element of the test is the participant's compensation. IRC Section 401(a)(4) sets the definition of what constitutes compensation for this purpose.

1. Treas. Reg. §1.401(l)-1(c)(7)(i).
2. See Rev. Rul. 2014-3, 2014-2 IRB 259 for the 2014 covered compensation table and Rev. Rul. 2013-2, 2013-10 IRB 533 for the 2013 covered compensation table.
3. IRC Sec. 401(l)(5)(C). Treas. Regs. §§1.401(l)-1(c)(2), 1.401(a)(4)-3(e)(2).
4. IRC Sec. 401(l)(5)(D); Treas. Reg. §1.401(l)-1(c)(17).
5. Treas. Regs. §§1.401(l)-3(d)(9), 1.401(l)-3(e).
6. Treas. Reg. §1.401(l)-5.
7. Treas. Reg. §1.401(l)-5(b)(1).
8. Treas. Regs. §§1.401(l)-5(c)(1)(i), 1.401(l)-5(c)(2).

Second, plans must specify the types of compensation that are used to determine benefits or contributions under the plan.

Third, compensation is used to determine if certain employees are to be treated as highly compensated employees in the nondiscrimination testing.

The nondiscrimination rules of the IRC generally refer to nondiscriminatory compensation as compensation meeting the requirement of IRC Section 414(s). That definition then is tied to the definition of compensation under IRC Section 415(c)(3) and allows for certain modifications.

That listing is not all inclusive, and other definitions of compensation may be used in various testing. For, example, plans must limit the maximum amount of compensation used to determine benefits or to test for prohibited nondiscrimination. No compensation in excess of $260,000 in 2014 (up from $255,000 in 2013) may be taken into account for these purposes (Q 3824F).[1] The limit is indexed for inflation in increments of $5,000.[2]

IRC Section 415(c)(3) compensation is the compensation of the participant from the employer for the year.

IRC Section 415(c)(3) compensation is determined under one of the following definitions: currently includible compensation,[3] W-2 compensation,[4] and wages for income tax withholding.[5] The regulations provide a degree of latitude in modifying each of these definitions of compensation.

Compensation generally includes elective deferrals as well as any amounts contributed or deferred by the employer at the election of the employee that are excluded from income under a cafeteria plan, a qualified transportation fringe benefit plan, or an IRC Section 457 plan.[6] IRC Section 414(s) permits an employer to either exclude or include such deferrals, as described below.

Employers may demonstrate that a definition of compensation is nondiscriminatory using snapshot testing on a single day during the plan year, provided that that day is representative of the employer's work force and the plan's coverage throughout the plan year.[7] This is seldom used in a small plan.

A definition of compensation other than IRC Section 415(c)(3) compensation still can satisfy IRC Section 414(s) if it meets the safe harbor definition or meets one of the alternative

1. IRC Secs. 401(a)(17), 414(s)(1); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
2. IRC Sec. 401(a)(17); see Treas. Reg. §1.401(a)(17)-1(a).
3. See Treas. Reg. Section 1.415(c)-2(b)(1).
4. See Treas. Reg. Section 1.415(c)-2(d)(4).
5. See Treas. Reg. 1.415(c)-2(d)3.
6. IRC Sec. 415(c)(3)(D).
7. Rev. Proc. 93-42, 1993-2 CB 540, modified by Rev. Proc. 95-34, 1995-2 CB 385.

definitions plus a nondiscrimination test.[1] The safe harbor definition is IRC Section 415(c)(3) compensation, reduced by:

(1) reimbursements or other expense allowances,

(2) cash and non-cash fringe benefits,

(3) moving expenses,

(4) deferred compensation, and

(5) welfare benefits.[2]

An alternative definition that defines compensation based on the rate of pay of each employee satisfies IRC Section 414(s) if the definition is nondiscriminatory and meets certain other requirements specified in the regulations.[3]

An employer generally may elect not to treat any of the following items as compensation: (1) elective contributions to a cafeteria plan, a qualified transportation fringe benefit plan, an IRC Section 401(k) arrangement, a cash or deferred SEP, or a tax sheltered annuity; (2) compensation deferred under a Section 457 plan; and (3) employee contributions to a government employer pick-up plan.[4]

Any other reasonable alternative definition of compensation can satisfy IRC Section 414(s) if it does not favor, by design, highly compensated employees and if it meets a nondiscriminatory requirement. An alternative definition of compensation meets the nondiscriminatory requirement if the average percentage of total compensation included under the alternative definition for the employer's highly compensated employees as a group does not exceed, by more than a *de minimis* amount, the average percentage of total compensation included under the alternative definition for the employer's other employees as a group.[5] Self-employed individuals are subject to special rules for purposes of using an alternative definition.[6]

Compensation may have a slightly different definition for other purposes of the IRC.

Section 415 Limits

3784. What are the Section 415 limits for qualified plans?

IRC Section 415 sets maximum levels for the annual contributions that may be made for any one participant under a defined contribution plan and the maximum accruals for participants under a defined benefit plan. A plan is qualified only if the plan document precludes

1. IRC Sec. 414(s)(3).
2. Treas. Reg. §1.414(s)-1(c)(3).
3. Treas. Reg. §1.414(s)-1(e).
4. IRC Sec. 414(s)(2); Treas. Reg. §1.414(s)-1(c)(4).
5. Treas. Reg. §1.414(s)-1(d).
6. See Treas. Regs. §§1.414(s)-1(d)(3)(iii)(B), 1.414(s)-1(g).

the possibility that benefits or contributions will exceed the limitations set forth in IRC Section 415 for any limitation year.[1]

For limitation years beginning in 2014, the highest annual benefit payable that may be paid under a defined benefit plan or under all such plans aggregated, if the employer has more than one, at the plan's normal retirement age (that is, at least sixty-two) must not exceed the lesser of 100 percent of the participant's average compensation during his or her high three years of service, or $210,000 (in 2014, as indexed from $205,000 in 2013).[2] See Q 3668 for further discussion on the application of the Section 415 limits to defined benefit plans.

The contribution limits applicable to defined contribution plans generally are referred to as the "annual additions limit." The annual additions limit is the maximum total allocation permitted to a participant's account (this calculation includes all such accounts in any defined contribution plan of the employer). The annual additions for any participant under a defined contribution plan must not exceed the lesser of 100 percent of the participant's compensation or $52,000 (as indexed for 2014, up from $51,000 in 2013).[3] See Q 3677 for details on the application of the Section 415 limits to defined contribution plans. All allocations to the account (other than "catch-up" contributions to a 401(k) plan and investment earnings) including salary deferrals, employer match, employer profit sharing contribution, employee contributions, and forfeiture reallocations are included as an annual addition in applying this limit.

Unless the plan document provides otherwise, a limitation year is the calendar year.[4] Contributions in excess of the Section 415 limits disqualify a plan for the year made and all subsequent years until such excess is corrected.[5] The regulations referenced here are effective for limitation years beginning on or after July 1, 2007.[6]

For purposes of the Section 415 limits, a benefit provided to an alternate payee of a participant pursuant to a qualified domestic relations order ("QDRO") (Q 3816) is treated as if it were provided to the participant.[7]

A controlled group of corporations or a group of trades or businesses under common control (Q 3830) or all members of an affiliated service group (Q 3832) are considered one employer for purposes of applying the limitations on contributions or benefits.[8] Thus, annual additions to any plan of the group are treated as made to a single plan.

A plan may incorporate the Section 415 limits by reference and will not fail to meet the definitely determinable benefit requirement (for defined benefit plans) or the definite

1. See IRC Sec. 401(a)(16); Treas. Reg. §1.415(a)-1(d).
2. IRC Sec. 415(b)(1); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
3. IRC Sec. 415(c); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
4. Treas. Reg. §1.415(j)-1(a).
5. Treas. Reg. §1.415(a)-1(a)(3); *Martin Fireproofing Profit Sharing Plan and Trust v. Comm.*, 92 TC 1173 (1989); *Hollen v. Comm'r*, T.C. Memo 2011-2 (2011), 437 Fed. App'x 525 (8th Cir. 2011), *cert. denied*, 132 S. Ct. 2443 (2012).
6. 72 Fed. Reg. 16878 (April 15, 2007).
7. Treas. Reg. §1.415(a)-1(f)(6).
8. IRC Secs. 415(g), 415(h), 414(m); see Treas. Reg. §1.415(a)-1(f)(2).

predetermined allocation formula requirement (for defined contribution plans) merely because it incorporates the limits of IRC Section 415 by reference.[1]

Vesting

3785. What vesting standards must a qualified plan meet?

A plan must meet certain minimum standards regarding the non-forfeitability of retirement accounts or accrued benefits.[2] This is determined by the plan's vesting schedule. Defined benefit plans that are top heavy may be subject to an accelerated vesting schedule (Q 3823).

Five basic requirements generally apply to the vesting of participant benefits:

(1) full vesting at the plan's retirement age,

(2) full vesting at the termination of the plan,

(3) full vesting of salary deferrals and employee contributions, and

(4) a plan must meet either the cliff vesting or the scheduled vesting requirements under all other circumstances,

(5) a plan amendment may not reduce a participant's vested benefit.

An employee's right to his or her normal retirement benefit must be non-forfeitable on the attainment of normal retirement age.[3] Normal retirement age is defined in the IRC as the earlier of normal retirement age under the plan, or the later of age sixty-five or the fifth anniversary of the date participation commenced.[4] An employee's rights in his or her accrued benefit derived from his or her own contributions must be non-forfeitable.[5]

Defined Benefit Plans

A defined benefit plan (Q 3666) that is not structured as a cash balance plan or that is not top heavy, as determined under IRC Section 416, must provide vesting based on credited service that is at least as favorable as one of two schedules (IRC Section 411(a)(1)):

(1) Under the five year cliff vesting schedule, an employee who has at least five years of credited service must have a non-forfeitable right to 100 percent of his or her accrued benefit derived from employer contributions.[6]

(2) Under the three to seven year vesting schedule, an employee who has completed at least three years of credited service must have a non-forfeitable right to at least the following percentages of his or her accrued benefit derived from employer

1. Treas. Reg. §1.415(a)-1(d)(3).
2. IRC Sec. 401(a)(7).
3. IRC Sec. 411(a).
4. IRC Sec. 411(a)(8).
5. IRC Sec. 411(a)(1).
6. IRC Sec. 411(a)(2)(A)(ii); see Temp. Treas. Reg. §1.411(a)-3T(b).

contributions: 20 percent after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.[1]

A defined benefit plan structured as a cash balance plan must provide full vesting at the completion of three years of creditable service.

Defined Contribution and Top Heavy Plans

All defined contribution plans and top-heavy defined benefit plans are required to provide vesting based on a participant's credited years of service that are at least as favorable as one of the following two schedules (Q 3674):

(1) Under the three year cliff vesting schedule, an employee who has at least three years of service must have a non-forfeitable right to 100 percent of his or her accrued benefit derived from employer contributions.[2]

(2) Under the two to six year vesting schedule, an employee who has completed at least two years of service must have a non-forfeitable right to at least the following percentages of his or her accrued benefit derived from employer contributions: 20 percent after two years of service, 40 percent after three years of service, 60 percent after four years of service, 80 percent after five years of service, and 100 percent after six years of service.[3]

Vesting can be determined based on all accounts in the plan or may provide separate schedules for various types of accounts (e.g., match, deferral, profit sharing account). It generally is not permissible for one group of employees to be subject to one vesting schedule and another group subject to another schedule in the same plan.[4] Where there is a pattern of abuse relating to vesting or changes in vesting (such as dismissing employees to prevent vesting), a more rapid rate of vesting may be required.[5] The determination of whether there is a pattern of abuse depends solely on the facts and circumstances in each case.[6]

Planning Point: Firing an employee to prevent vesting is also a violation of ERISA Section 510.

Rate of Benefit Accruals or Allocations

If an employee's benefit accruals or allocations (in the case of a defined contribution plan) cease, or if the rate of an employee's benefit accrual or rate of allocation is reduced because of the attainment of any age, the plan will not satisfy the IRC's vesting requirements.[7]

1. IRC Sec. 411(a)(2)(A)(iii); see Temp. Treas. Reg. §1.411(a)-3T(c).
2. IRC Sec. 411(a)(2)(B)(ii).
3. IRC Sec. 411(a)(2)(B)(iii).
4. Temp. Treas. Reg. §1.411(a)-3T(a)(2).
5. ERISA Conf. Comm. Report, 1974-3 CB 437.
6. Prop. Treas. Reg. §1.411(b)-1; IR 80-85.
7. IRC Secs. 411(b)(1)(H), 411(b)(2).

Changes in Vesting Schedule

If a plan's vesting schedule is modified by a plan amendment, each participant with at least three years of service must be permitted to elect to have his or her non-forfeitable percentage computed under the plan without regard to the amendment.[1]

Permitted Forfeitures

The vesting rules do not require a plan to provide a preretirement death benefit aside from the employee's accrued benefit derived from his or her own contributions. The IRC provides that, "A right to an accrued benefit derived from employer contributions shall not be treated as forfeitable solely because the plan provides that it is not payable if the participant dies," except as required by the survivor annuity provisions (Q 3792).[2]

A reversion to the employer of contributions made under a mistake of fact or a mistake as to deductibility is not a forfeiture even if it results in adjustment of an entirely or partially non-forfeitable account, provided the return is limited to an amount that does not reduce a participant's balance below what it would have been had the mistaken amount not been contributed.[3]

Without violating the non-forfeitability rules, a plan may provide that payment of benefits to a retired employee is suspended for any period during which the retired employee resumes active employment with the employer who maintains the plan or, in the case of a multiemployer plan, in the same industry, the same trade or craft, and the same geographic area covered by the plan as when his or her benefits commenced.[4] The provision must be carefully drafted and administered to comply with applicable regulations and rulings.[5]

Plan Termination or Discontinuance of Contributions

A plan must provide that on its termination or partial termination (or, in the case of a profit sharing plan, also on complete discontinuance of contributions), benefits accrued to the date of termination or to the date of discontinuance of contributions become non-forfeitable to the extent funded at such date.[6]

The merger or conversion of a money purchase pension plan into a profit sharing plan generally does not result in a partial termination and accelerated vesting provided that all employees who are covered by the money purchase plan remain covered under the continuing profit sharing plan, the money purchase plan assets and liabilities retain their characterization under the profit sharing plan, and employees vest in the profit sharing plan under the same vesting schedule that existed under the money purchase plan.[7]

1. IRC Sec. 411(a)(10); see Temp. Treas. Reg. §1.411(a)-8T(b).
2. IRC Sec. 411(a)(3)(A).
3. Rev. Rul. 91-4, 1991-1 CB 54.
4. IRC Sec. 411(a)(3)(B).
5. See Labor Reg. §2530.203-3; Rev. Rul. 81-140, 1981-1 CB 180; Notice 82-23, 1982-2 CB 752.
6. IRC Sec. 411(d)(3); Treas. Reg. §1.411(d)-2.
7. Rev. Rul. 2002-42, 2002-2 CB 76.

A complete discontinuance may be deemed to have occurred when amounts contributed by an employer are not substantial enough to reflect an intent to continue to maintain the plan. Failure to make substantial and recurring contributions generally is regarded as a discontinuance of the plan. If this occurs solely because there are no current or accumulated profits, it may not constitute discontinuance as long as it is reasonable to expect contributions in future years.[1]

Whether discontinuance has occurred depends on all the facts and circumstances. Thus, a plan provision that states discontinuance will occur only when the ratio of aggregate contributions to compensation falls below a predetermined figure does not meet this qualification requirement and would need to be removed from the document.[2]

Reduction of Benefits by Offset

Vesting requirements are not violated by a provision requiring pension payments to be reduced, or offset, by amounts received by the pensioner under a state workers' compensation law. Furthermore, state laws prohibiting offset of retirement benefits by workers' compensation benefits are preempted by ERISA.[3]

Vesting requirements were not violated where, under a severance pay plan, an employee's severance pay was reduced by the actuarial value, at discharge, of the employee's vested interest in a qualified pension plan. The severance pay plan was not a pension plan under ERISA subject to vesting standards.[4]

A pension plan whose benefits may be offset by benefits under a profit sharing plan will be considered to satisfy benefit accrual requirements if the accrued benefit, determined without regard to the offset, satisfies the vesting requirements and the offset is equal to the vested portion of the account balance in the profit sharing plan (or to a specified portion of the vested account balance).[5]

Definitions

"Normal retirement benefit" means the employee's accrued benefit without regard to whether it is vested; thus, a plan cannot qualify if it provides no retirement benefits for employees who reach normal retirement age with fewer than five years of vesting service.[6] A plan that provides that an employee's right to his or her normal retirement benefit becomes non-forfeitable on his or her normal retirement date will fail to meet this requirement if the normal retirement date, as defined in the plan, may occur after the employee's "normal retirement age" as defined in IRC Section 411 (e.g., where normal retirement date is defined in the plan to be the first day of the calendar month following the employee's sixty-fifth birthday).[7]

1. Rev. Rul. 80-146, 1980-1 CB 90.
2. Rev. Rul. 80-277, 1980-2 CB 153.
3. *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504 (1981).
4. *Spitzler v. New York Post Corp.*, 620 F.2d 19 (2d Cir. 1980).
5. Rev. Rul. 76-259, 1976-2 CB 111.
6. See Rev. Rul. 84-69, 1984-1 CB 125. See also *Board of Trustees of N.Y. Hotel Trades Council & Hotel Assoc. of N.Y. City, Inc. Pension Fund v. Comm.*, TC Memo 1981-597; *Trustees of the Taxicab Indus. Pension Fund v. Comm.*, TC Memo 1981-651; *Caterpillar Tractor Co. v. Comm.*, 72 TC 1088 (1979).
7. Rev. Rul. 81-211, 1981-2 CB 98.

"Accrued benefit" means, in the case of a defined benefit plan, the employee's accrued benefit determined under the plan (Q 3667) expressed in the form of an annual benefit commencing at normal retirement age, or, in the case of any other kind of plan, the balance of the employee's account.[1] The accrued benefit of a participant generally may not be decreased by an amendment to the plan (Q 3786).

The term "year of service" generally means a twelve month period, typically the plan year, designated by the plan during which an employee has worked at least 1,000 hours (although that amount may be less). It also may be measured using an elapsed time method.[2] All years of an employee's service with the employer are taken into account for purposes of computing the non-forfeitable percentages specified above except those years specifically excluded in IRC Section 411(a).[3] That section permits a plan to exclude service before age eighteen, or service prior to the effective date of the plan.

A right to an accrued benefit is considered to be non-forfeitable at a particular time if, at that time and thereafter, it is an unconditional right.[4] Some courts have made a distinction between vesting and non-forfeitability. A participant is vested when he or she has an immediate, fixed right of present or future enjoyment of his or her accrued benefit. A plan may provide that a vested benefit will be forfeited in whole or in part if, for example, the participant terminates his or her employment and goes to work for a competitor of the employer or commits a crime against the employer.[5] Thus, for example, a participant could be offered immediate 100 percent vesting of his or her benefit under a plan, but the benefit could be forfeitable (to the extent the benefit would not be vested under the closest IRC and ERISA schedules) if the employee commits certain forbidden acts.

Several circuit courts have held that forfeiture provisions are enforceable only to the extent that the accrued benefit forfeited by commission of the forbidden act is in excess of the non-forfeitable accrued benefit derived from employer contributions to which the participant was entitled under the nearest equivalent ERISA vesting schedule at the time the forfeiture occurred.[6] The temporary regulations generally follow this reasoning.[7]

3786. What is the anti-cutback rule and to which benefits does it apply?

ERISA and the Code contain provisions that protect participants and beneficiaries. The anti-cutback rule prohibits a plan amendment that decreases, directly or indirectly, the accrued benefit of a participant.[8] An exception may be available in certain cases of substantial business hardship; see below.

1. IRC Sec. 411(a); Treas. Reg. §1.411(a)-7.
2. IRC Sec. 411(a)(5).
3. Treas. Regs. §§1.411(a)-5, 1.411(a)-6.
4. Temp. Treas. Reg. §1.411(a)-4T(a).
5. Rev. Rul. 85-31, 1985-1 CB 153.
6. *Clark v. Lauren Young Tire Center Profit Sharing Trust*, 816 F.2d 480 (9th Cir. 1987); *Noell v. American Design, Inc.*, 764 F.2d 827 (11th Cir. 1985); *Fremont v. McGraw Edison*, 606 F.2d 752 (7th Cir. 1979); *Hepple v. Roberts & Dybdahl, Inc.*, 622 F.2d 962 (8th Cir. 1980); *Hummell v. S.E. Rykoff & Co.*, 634 F.2d 446 (9th Cir. 1980).
7. See Temp. Treas. Reg. §1.411(a)-4T.
8. IRC Sec. 411(d)(6)(A); ERISA Sec. 204(g).

Except as otherwise provided below, a plan amendment that has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy, or eliminating certain optional forms of benefit attributable to service before the amendment is treated as impermissibly reducing accrued benefits.[1] Regulations include a list of benefits that are not protected in Treasury Regulation Section 1.411(a)-4, A-1(d).

The anti-cutback rule does not prohibit any plan amendment that reduces or eliminates benefits or subsidies that create significant burdens or complexities for the plan and plan participants unless the amendment adversely affects the rights of any participant in a more than *de minimis* manner.[2] If a series of plan amendments made at different times have the effect, when taken together, of reducing or eliminating a protected benefit in a more than *de minimis* manner, the amendment will violate IRC Section 411(d)(6).[3]

Employee stock ownership plans ("ESOPs") (Q 3742) will not be treated as failing to meet the anti-cutback requirement merely on account of modifying distribution options in a nondiscriminatory manner.[4]

Transfers Between Plans

Benefits that are protected under IRC Section 411(d)(6) may not be eliminated by reason of a transfer or any transaction amending or having the effect of amending a plan to transfer benefits. A defined contribution "transferee" plan (e.g., in a merger, acquisition, consolidation, or similar transaction) will not be treated as failing the anti-cutback rule merely because the transferee plan does not provide some or all of the forms of distribution previously available under a transferor plan, if certain requirements are met.[5]

Elimination of a Form of Distribution

Except to the extent provided in regulations, a defined contribution plan will not be treated as failing the anti-cutback rule merely because of the elimination of a form of distribution previously available under the plan, provided that, with respect to any participant, a single sum payment is available to the participant at the same time or times as the form of distribution being eliminated and the single sum payment is based on the same or greater portion of the participant's account as the form of distribution being eliminated.[6]

3787. Are there any circumstances where a plan may be amended to eliminate an optional form of benefit? What is the redundancy rule?

A plan generally may be amended to eliminate an optional form of benefit with respect to benefits accrued before the amendment date if the optional form of benefit is redundant with

1. IRC Sec. 411(d)(6)(B); see Treas. Reg. §1.411(d)-4, A-1(a).
2. IRC Sec. 411(d)(6)(B).
3. Treas. Reg. §1.411(d)-4, A-2(c).
4. IRC Sec. 411(d)(6)(C); Treas. Reg. §1.411(d)-4, A-2(d); Notice 2013-17, 2013-20 IRB 1082.
5. IRC Sec. 411(d)(6)(D); see Treas. Reg. §1.411(d)-4, A-3(b).
6. IRC Sec. 411(d)(6)(E).

a retained optional form of benefit.[1] For this purpose, the regulations identify six basic "families" of optional forms of benefit:

(1) the 50 percent or more joint and contingent family,

(2) the below 50 percent joint and contingent family,

(3) the ten years or less term certain and life annuity family,

(4) the greater than ten years term certain and life annuity family,

(5) the ten years or less level installment family, and

(6) the greater than ten years level installment family.[2]

The redundancy rule does not apply to certain "core options" unless the retained optional form of benefit and the eliminated option are identical except for differences described in the proposed regulations.[3]

As an alternative to the redundancy rule, an employer is permitted to eliminate a protected benefit if the amendment does not apply to participants with annuity starting dates less than four years after the date the amendment is adopted and certain "core options" are retained.[4]

The core options generally mean

(1) a straight life annuity,

(2) a 75 percent joint and contingent annuity,

(3) a ten year certain and life annuity, and

(4) the most valuable option for a participant with a short life expectancy.[5]

Planning Point: A plan may be amended to meet the requirements of IRC Section 436 regarding benefit accruals and limitations without violating the anti-cutback rule. Notice 2011-96 provides a sample plan amendment.[6] Notice 2012-70 extends the period by which such amendment may be adopted without violating IRC Section 411(d)(6).[7]

Special rules apply to plans in bankruptcy that allow the plan to eliminate optional forms of benefit that violates IRC Section 436 without violating IRC Section 411(d)(6).[8]

1. Treas. Reg. §1.411(d)-3(c)(1)(ii).
2. Treas. Reg. §1.411(d)-3(c)(4).
3. See Treas. Reg. §1.411(d)-3(c)(2)(ii).
4. Treas. Reg. §1.411(d)-3(d).
5. Treas. Reg. §1.411(d)-3(g)(5).
6. 2011-52 IRB 915.
7. Notice 2012-70, 2012-2 CB 712.
8. TD 9601 (Mar. 4, 2013) (adding 1.411(d)-4A-2(b)(2)(xii)).

3788. What benefits are protected by the anti-cutback rule?

An employee's accrued benefit under a defined contribution plan is the value of the employee's account plus amounts to which the participant is entitled under the terms of the plan. These additional amounts include contributions that have accrued but have not been credited to the account due to a delay in the bookkeeping process.[1] Thus, a retroactive amendment to a defined contribution plan's allocation formula after the contribution for the year had been made but before the allocation to a participant's account had occurred was determined to have violated IRC Section 411(d)(6) because it reduced the amounts allocated to some of the participants.[2]

The basic rule followed by most professionals is that once a participant has accrued a right to a contribution, say once the participant has met a 1,000 hours of credited service plan requirement, the formula cannot be modified to lower benefits to any employee, although this is not a bright line threshold.

The elimination of a cost-of-living adjustment ("COLA") provision through termination of a plan violated the ERISA prohibition against the reduction of accrued benefits.[3] But see Q 3789.

It also been held that a company's elimination of a lump sum distribution option, resulting in a decrease in former employees' accrued benefits, violated the ERISA provision and IRC Section 411(d)(6).[4]

The U.S. Supreme Court has determined that the rule prohibiting cutbacks of early retirement benefits or retirement-type subsidies was violated when a company adopted a plan amendment expanding the range of post-retirement employment that would disqualify retired construction workers from receiving pension benefits.[5] The IRS followed with guidance limiting the retroactive application of this provision.[6] Final regulations take the position that a plan amendment may not impose new restrictions on a participant's rights to benefits that are protected under IRC Section 411(d)(6), whether or not the amendment would otherwise be permitted under the IRC.[7]

A change in actuarial factors may result in a violation of the anti-cutback rule. A cash balance plan (Q 3669) violated the rule where its use of a lower interest rate than was guaranteed by the plan resulted in a taxpayer receiving less than the actuarial equivalent of the taxpayer's normal retirement benefit.[8]

1. TAM 9735001.
2. See TAM 9735001.
3. *Hickey v. Chicago Truck Drivers, Helpers and Warehouse Workers Union*, 980 F.2d 465 (7th Cir. 1992).
4. *Auwarter v. Donohue Paper Sales Corp. Defined Benefit Pension Plan*, 802 F. Supp. 830 (E.D.NY 1992).
5. *Central Laborers' Pension Fund v. Heinz*, 124 S.Ct. 2230 (2004).
6. See Rev. Proc. 2005-23, 2005-18 IRB 991, as modified by Rev. Proc. 2005-76, 2005-2 C.B. 1139.
7. See TD 9280, 71 Fed. Reg. 45379 (Aug. 9, 2006).
8. See *Edsen v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000).

The IRS has provided guidance as to when a change in actuarial factors will indirectly affect accrued benefits, as well as acceptable methods for preventing a violation of the vesting rules as a result of such a change.[1]

3789. What benefits are not protected by the anti-cutback rule?

Despite the fact that a COLA provision may constitute an essential element of an accrued benefit,[2] a COLA provision was not an accrued benefit with respect to retirees who retired before the provision was adopted, even though it was made available to them.[3]

Regulations permit profit sharing or stock bonus plans (as well as cash or deferred arrangements) to be amended to eliminate hardship withdrawal provisions, without violating IRC Section 411(d)(6).[4]

Plan amendments adopted within the remedial amendment period that are necessary to bring a plan into compliance with the IRC or to prevent unintended benefit increases as a result of an IRC amendment generally are afforded relief from IRC Section 411(d)(6).[5] Thus, for example, the elimination of the right to receive employer securities from an S corporation ESOP does not violate IRC Section 411(d)(6).[6] The elimination of the right to receive a distribution prior to retirement after age 70½ (Q 3803) also does not do so, if certain conditions are met.[7]

The following benefits are not protected under IRC Section 411(d)(6) and may be reduced or otherwise amended:

(1) ancillary life insurance protection,

(2) accident or health insurance benefits,

(3) availability of loans,

(4) the right to make after-tax contributions or elective deferrals, and

(5) the right to direct investments.[8]

Ancillary benefits, other rights or features, and any other benefits not described in IRC Section 411(d)(6) are not protected under IRC Section 411(d)(6).[9]

Despite the protection provided to early retirement benefits, the IRS determined that where an employer offered an early retirement window benefit repeatedly for substantially

1. See Rev. Rul. 81-12, 1981-1 CB 228.
2. See *Hickey v. Chicago Truck Drivers, Helpers and Warehouse Workers Union*, 980 F.2d 465 (7th Cir. 1992).
3. *Sheet Metal Workers' Nat'l Pension Fund Bd. of Trustees v. Comm.*, 117 TC 220 (2001), *aff'd*, 318 F.3d 599 (4th Cir. 2003).
4. Treas. Reg. §1.411(d)-4, A-2(b)(2)(x).
5. See, e.g., Rev. Proc. 94-13, 1994-1 CB 566 (reduction of compensation limit under IRC Sec. 401(a)(17)); Notice 99-44, 1999-2 CB 326 (repeal of combined plan limit).
6. See Treas. Reg. §1.411(d)-4, A-2(d).
7. See Treas. Reg. §1.411(d)-4, A-10.
8. Treas. Reg. §1.411(d)-4, A-1(d); see Rev. Rul. 96-47, 1996-2 CB 35.
9. See Treas. Reg. §1.411(d)-4, A-1(d).

consecutive, limited periods of time, its failure to offer the benefit permanently did not violate IRC Section 411(d)(6).[1]

3790. What special rules are related to the anti-cutback rule?

Plans subject to the funding standards of ERISA Section 302 (generally, defined benefit plans, money purchase pensions and target benefit plans), must meet a notice requirement if the plan is amended in a manner that significantly reduces the participants' rate of future benefit accruals.[2]

Under limited circumstances, a retroactive plan amendment reducing benefits may be available in the case of a substantial business hardship where it is determined that a waiver of the minimum funding standard (Q 3692) is unavailable or inadequate.[3] Among the factors the IRS will consider in determining whether a substantial business hardship exists are whether:

(1) the employer is operating at an economic loss,

(2) there is substantial unemployment or underemployment in the trade or business and the industry concerned,

(3) the sales and profits of the industry are depressed or declining, and

(4) it is reasonable to expect that the plan will be continued only if the waiver is granted.[4]

The IRS permitted such an amendment to a plan whose sponsor was insolvent and expected no additional revenues, but the plan's only participants and the sponsor's only employees were the five owners of the business.[5]

Automatic Survivor Benefits

3791. What plans are subject to the automatic survivor benefit requirements?

The requirement that a plan provide the qualified joint and survivor annuity ("QJSA") and qualified preretirement survivor annuity ("QPSA") forms of benefit (Q 3792) applies to all defined benefit plans, to all defined contribution plans that are subject to minimum funding standards (e.g., target benefit and money purchase pensions), and to profit sharing plans that include annuity provisions as the normal form of benefit.[6]

The automatic survivor benefit requirements also may apply to any participant under any other defined contribution plans unless, (1) the plan provides that in the event of the participant's death, his or her non-forfeitable accrued benefit will be paid in full to his or her surviving spouse

1. Rev. Rul. 92-66, 1992-2 CB 92.
2. ERISA Sec. 204(h).
3. IRC Sec. 412(d)(2).
4. IRC Sec. 412(c)(2).
5. See Let. Rul. 9736044.
6. IRC Sec. 401(a)(11)(B).

or to another designated beneficiary if the spouse consents or if there is no surviving spouse; (2) the participant does not elect payment of benefits in the form of a life annuity; and (3) with respect to such participant, the plan is not a direct or an indirect transferee of a plan to which the automatic survivor annuity requirements apply.[1]

The automatic survivor benefit requirements will not apply to the portion of benefits accrued under a tax credit ESOP or leveraged ESOP if the participant has the right to demand distribution in the form of employer securities or to require repurchase by the employer of non-publicly traded securities.[2]

3792. What survivor benefits must be provided under a qualified plan?

Plans that are subject to the automatic survivor benefit requirements (Q 3791), sometimes referred to as the QJSA requirements, must provide that, unless waived by the participant with the consent of the spouse (Q 3800), retirement benefits will be paid in the form of a "qualified joint and survivor annuity."[3]

An unmarried participant must be provided with a life annuity, unless he or she elects another form of benefit.[4]

Furthermore, such plans must provide that if a vested participant dies prior to the annuity starting date, benefits will be paid to a surviving spouse in the form of a "qualified preretirement survivor annuity."

This benefit requirement may be waived by the participant with the consent of his or her spouse (Q 3800).

These requirements apply to all pension plans but only to certain profit sharing plans. This requirement only applies to profit sharing plans where the document specifies the normal form of benefit is payable as an annuity or where the profit sharing plan contains pension plan assets of a plan of the employer that were merged into the profit sharing plan. Most profit sharing plans do not specify that benefits be paid in the form of an annuity.[5]

When a plan is subject to these requirements, notices are required advising the participant and spouse of their benefits. Thus, benefits cannot be paid from a pension plan unless the participant (and spouse, if married) elects not to receive the annuity payment.

An exception to these general rules applies if the present value of the participant's benefit does not exceed $5,000 and the plan specifies that a lump sum payout will be paid without need for either the participant's or spouse's consent. This payment is only available if the participant

1. IRC Sec. 401(a)(11)(B); Treas. Reg. §1.401(a)-20, A-3.
2. IRC Secs. 401(a)(11)(C), 409(h).
3. IRC Sec. 401(a)(11); Treas. Reg. §1.401(a)-20.
4. Treas. Reg. §1.401(a)-20, A-25.
5. Treas. Reg. §1.401(a)-20, A-11.

and the particiipants's spouse (or surviving spouse) consent in writing if payment is after the participant's annuity starting date.[1]

The annuity starting date is the first day of the first period for which an amount is payable as an annuity regardless of when or whether payment is actually made or, in the case of benefits not payable in the form of an annuity, the date on which all events have occurred that entitle the participant to the benefit.[2] This requirement applies only to those benefits in which a participant was vested immediately prior to his or her death under a defined benefit plan and to all non-forfeitable benefits that are payable under a defined contribution plan.[3]

3793. What is a qualified joint and survivor annuity ("QJSA")?

A qualified joint and survivor annuity ("QJSA") is an annuity (1) for the life of the participant, with a survivor annuity for the life of his or her spouse that is not less than one-half (nor greater than 100 percent) of the amount of the annuity payable during the joint lives of the participant and his or her spouse, and (2) that is the actuarial equivalent of a single annuity for the life of the participant.[4]

With respect to married participants, the qualified joint and survivor annuity must be at least as valuable as any other optional form of benefit payable under the plan at the same time. If a plan has two joint and survivor annuities that satisfy the QJSA requirements and one has a greater actuarial value than the other, the more valuable one is the QJSA. If a plan offers two actuarially equivalent joint and survivor annuities that meet the QJSA requirements, it may designate which joint and survivor annuity is the QJSA and allow a participant to elect out of the designated QJSA in favor of the equal QJSA without spousal consent.[5]

A plan subject to the QJSA requirements must permit a participant to receive a distribution under a QJSA when the participant attains the earliest retirement age under the plan. The earliest retirement age is the earlier of the earliest age at which a participant could receive a distribution under the plan or the early retirement age determined under the plan (or, if no early retirement age, the normal retirement age under the plan).[6]

3794. What is a qualified preretirement survivor annuity ("QPSA")?

A qualified preretirement survivor annuity ("QPSA") is a survivor annuity for the life of the surviving spouse of the participant under which payments are to begin no later than the month in which the participant would have reached the earliest retirement age provided under the plan and that also meets the following requirements with respect to the amount of the annuity:

(1) In the case of a defined contribution plan, the survivor annuity is the actuarial equivalent of the participant's account and must not be less than one-half of the

1. IRC Sec. 417(e)(1); Treas. Reg. §1.417(e)-1(b)(2)(i).
2. IRC Sec. 417(f)(2); Treas. Reg. §1.401(a)-20, A-10(b)(2).
3. Treas. Reg. §1.401(a)-20, A-12.
4. IRC Sec. 417(b).
5. Treas. Reg. §1.401(a)-20, A-16.
6. Treas. Reg. §1.401(a)-20, A-17.

participant's vested account balance as of the date of his or her death unless waived by the participant and spouse.[1]

(2) In the case of all other plans, (x) if the participant died after the date the participant attained the earliest retirement age provided under the plan, the payments to the surviving spouse must not be less than the amounts that would have been payable under the survivor portion of a qualified joint and survivor annuity had the participant retired with an immediate qualified joint and survivor annuity on the day before he died, or (y) if the participant died on or before the date the participant would have reached the earliest retirement age, the payments to the surviving spouse must not be less than the amounts that would have been paid under the survivor portion of a QJSA had the participant separated from service on the earlier of the actual time of separation or death, survived to the earliest retirement age, retired with an immediate qualified joint and survivor annuity at the earliest retirement age, and died on the day after he or she reached the earliest retirement age.[2] In any case, payments to the surviving spouse must not violate the incidental benefit rule (Q 3751).[3]

A defined benefit plan must permit the surviving spouse to receive distributions under the QPSA no later than the month in which the participant would have attained the earliest retirement age. In the case of a defined contribution plan, the spouse must be permitted to elect to begin receiving payments under the QPSA within a reasonable time after the participant's death.[4]

3795. What is a qualified optional survivor annuity and how can it be used to satisfy the QJSA requirements for qualified plans?

In plan years beginning after December 31, 2007, a plan will satisfy the QJSA requirements only if a participant who has waived the QJSA may elect a qualified optional survivor annuity.[5] Spousal consent is not required to elect a qualified optional survivor annuity.

The term qualified optional survivor annuity means an annuity for the life of the participant with a survivor annuity for the life of the spouse that is equal to an "applicable percentage" of the amount of the annuity that is payable during the joint lives of the participant and spouse. For this purpose, if the survivor annuity percentage is less than 75 percent, the qualified optional survivor annuity percentage must be at least 75 percent. If the survivor annuity percentage is equal to or greater than 75 percent, the qualified optional survivor annuity percentage must be at least 50 percent.[6]

1. Treas. Reg. §1.401(a)-20, A-20.
2. IRC Sec. 417(c); Treas. Reg. §1.401(a)-20, A-18.
3. Sen. Fin. Comm. Rep. to P.L. 98-397. See Rev. Rul. 85-15, 1985-1 CB 132.
4. Treas. Reg. §1.401(a)-20, A-22.
5. IRC Sec. 417(a)(1)(A).
6. See IRC Sec. 417(g).

3796. Does a plan participant and the participant's spouse have to be married for a certain length of time before QJSA and QPSA requirements apply?

A plan generally is not required to provide either the QJSA or the QPSA (but may do so) if the participant and the spouse were not married throughout the one year period ending on the earlier of the participant's annuity starting date (see above) or the date of the participant's death. If a participant marries within one year before the annuity starting date and the participant and the participant's spouse were married for at least a one year period ending on or before the date of the participant's death, the participant and the spouse are treated as though they had been married throughout the one year period ending on the participant's annuity starting date.[1] Special rules may apply where there is a qualified domestic relations order ("QDRO") in effect that applies to plan benefits (Q 3816).

Planning Point: Because of the administrative difficulties involved, plan sponsors should consider whether the costs of imposing a one year of marriage requirement outweigh any potential savings. Where possible, plan sponsors should design plans to minimize the administrative processes for profit sharing plans.

3797. When is a profit sharing plan not subject to QJSA and QPSA requirements?

As noted above, unless a plan document is written to provide an annuity as the normal form of benefit, or if the plan contains pension assets that were merged into the profit sharing plan, QJSA and QPSA annuity rules do not apply. Another requirement, however, mandates that at least 50 percent of the benefit be paid to a surviving spouse. Under waiver rules similar to those discussed above, a spouse may agree to waive these rights and have the benefit paid to another beneficiary.

In 2012, the IRS issued Revenue Ruling 2012-3, which describes how the QJSA and QPSA rules apply when a deferred annuity contract is purchased under a profit-sharing plan.[2]

3798. What notice requirements apply to qualified plans subject to QJSA rules?

A plan subject to the QJSA rules generally must provide, within certain specified periods, each participant (vested and nonvested, married or unmarried) with a written explanation of the automatic survivor annuity forms of benefit, certain optional forms of benefit, and their relative values. The notice must explain the participant's (and his or her spouse's) rights with respect to waiving such benefits.[3] Notices of automatic survivor benefits generally may be provided in electronic form provided certain requirements are met.[4]

1. IRC Sec. 417(d); Treas. Reg. §1.401(a)-20, A-25(b)(2).
2. 2012-1 C.B. 383 (Feb. 2, 2012).
3. IRC Sec. 417(a)(3); see TD 9256, 71 Fed. Reg. 14798.
4. See Treas. Reg. §1.401(a)-21.

The explanation may be provided after the annuity starting date, but the applicable election period for waiving the benefit (Q 3800) may not end before the thirtieth day after the explanation is provided.[1] Under certain circumstances, a "retroactive annuity starting date" may be permitted (Q 3800).[2] The plan may allow the participant with any applicable spousal consent to waive the thirty day requirement if the distribution begins more than seven days after the explanation is provided.[3]

The explanation must include information on the financial effect and relative value comparisons of any optional forms of benefit compared to the value of the QJSA. This may be offered in the form of generally applicable information or as information that is specific to the participant to whom it is provided. Details and procedures for making the required disclosures, as well as a sample disclosure, are set forth in final regulations. These requirements generally are effective for QJSAs with annuity starting dates after February 1, 2006.[4]

A defined benefit pension plan that fully subsidizes a qualified survivor annuity is not required to provide an explanation unless it offers participants an election to waive the benefit or designate a beneficiary.[5]

3799. What special rules apply to plans that are subject to QJSA and QPSA requirements?

For plan years beginning before January 1, 2008, the present value of the accrued benefit generally must be determined using the annual interest rate on thirty year Treasury securities for the month before the date of distribution. Temporary regulations permit the employer to base the determination on a monthly, quarterly, or annual interest rate. The rate may be determined using any month during a "stability period" of up to five months, provided the plan specifies the month that will be used. In any event, the interest rate must be determined in a consistent manner that is applied uniformly to all plan participants.[6]

In plan years beginning after December 31, 2007, the present value of the accrued benefit generally must be determined using a mortality table specified in regulations and an interest rate derived from a three segment yield curve, phased in over five years.[7]

Corrective distributions of excess deferrals, excess contributions, and excess aggregate contributions (Q 3705, Q 3733) from a 401(k) plan are not subject to the QJSA or spousal consent rules.[8]

Plans that offer plan loans (Q 3848 to Q 3854) and are subject to the QJSA requirements generally must provide that no portion of the accrued benefit of the participant may be used as

1. IRC Sec. 417(a)(7).
2. See Treas. Reg. §1.417(e)-1(b)(3)(iv).
3. IRC Sec. 417(a)(7)(B); TD 8796, 1999-1 CB 344.
4. See Treas. Reg. §1.417(a)(3)-1(f)(1).
5. IRC Secs. 417(a)(3), 417(a)(5); See Treas. Reg. §1.401(a)-20, A-37.
6. IRC Sec. 417(e)(3), prior to amendment by PPA 2006; Treas. Reg. §1.417(e)-1(d)(4).
7. See IRC Sec. 417(e)(3).
8. Treas. Reg. §1.401(k)-2(b)(2)(vii)(A).

security for any loan unless, at the time the security agreement is entered into, the participant's spouse consents to the use of the accrued benefit as security.[1] If spousal consent is not obtained or is not required at the time benefits are used as security, it is not required at the time of any setoff of the loan against the accrued benefit, even if the participant is married to a different spouse at the time of the setoff.[2]

The IRS audits plans to determine if the consent rules have been met. Rev. Proc. 2013-12[3] explains the procedure to follow if distributions are made without spousal consent.

The automatic survivor benefit rules generally do not apply to a beneficiary who murders his or her participant spouse.[4] An employee's widow convicted of his murder was held entitled to receive the preretirement annuity where applicable state law made her a constructive trustee of the annuity.[5]

3800. When may survivor benefits required under a qualified plan be waived?

A qualified plan that is subject to the automatic survivor benefit rules generally must provide that participants may elect (or revoke an election) to waive the qualified joint and survivor annuity ("QJSA") or the qualified preretirement survivor annuity ("QPSA") forms of benefit (Q 3792) at any time during the applicable election period.[6] The participant may elect the qualified optional survivor annuity ("QOSA") at any time during the applicable election period.[7]

The plan also must provide that such an election will not be effective unless (1) the spouse of the participant, if any, consents in writing to the election, (2) the election designates a beneficiary or a form of benefits that may not be changed without spousal consent (unless the consent expressly permits future designations by the participant without further spousal consent), and (3) the consent acknowledges the effect of the election and is witnessed by a plan representative or notary public.[8]

An election made without the consent of the spouse is effective only if it is established to the satisfaction of a plan representative that there is no spouse, that the spouse cannot be located, or that certain other specified circumstances prevent securing such consent.[9] Caution should be exercised when following any of these exceptions as a missing spouse who suddenly resurfaces may be entitled to benefits that already have been fully paid to another beneficiary. Any consent by the spouse of a participant, or proof that consent cannot be obtained from the spouse, is effective only with respect to that spouse except in the case of plan benefits securing a loan (Q 3792).[10]

1. IRC Secs. 417(a)(1), 417(a)(4); Treas. Reg. §1.401(a)-20, A-24.
2. Treas. Reg. §1.401(a)-20, A-24(b).
3. 2013-4 I.R.B. 313.
4. See *Mendez-Bellido v. Board of Trustees of Div. 1181*, 709 F. Supp. 329 (E.D.N.Y. 1989). See also, Let. Ruls. 8908063, 8905058.
5. *George Pfau's Sons Co. v. Neal*, 665 NE 2d 68 (Ct. App. Ind. 1996).
6. IRC Sec. 417(a)(1)(a).
7. See IRC Sec. 417(a)(1)(a).
8. IRC Sec. 417(a)(2); Treas. Reg. §1.401(a)-20, A-31.
9. See Treas. Reg. §1.401(a)-20, A-27.
10. IRC Sec. 417(a)(2); Treas. Reg. §1.401(a)-20, A-29.

A spousal waiver that had not been properly witnessed or notarized was struck down despite the wife's acknowledgement that she had signed the form because the waiver did not meet the requirements clearly set forth in the IRC and ERISA.[1]

In an earlier district court ruling, the lack of a written, notarized spousal consent did not render the designation of a non-spouse beneficiary completely ineffective; the designation remained effective to the extent the benefits exceeded what was required to be paid to the spouse.[2] In another case, the Seventh Circuit held that where the husband was also the plan representative, his wife's consent was valid even though he did not witness it on behalf of the plan, because he knew the person who signed it was his wife.[3]

Prior consent to waive a benefit is not invalid simply because the benefit increased after the consent was given.[4]

A prenuptial agreement or similar contract entered into prior to marriage is not, by itself, effective to waive a widow's surviving spouse benefits,[5] based on parallel provisions found in ERISA Section 205(c) and IRC Section 417(a).[6] For a valid waiver to occur, ERISA requires a notarized waiver containing specific language by a spouse who actually is entitled, by marriage, to the statutory benefits being waived. In addition, the spouse executing the waiver must designate an alternative beneficiary.[7]

The Court of Appeals for the Eighth Circuit held that neither a prenuptial agreement with a participant's second wife, nor a separation agreement in which his first wife had "relinquished any right, title or interest in and to any … pension plans," constituted a valid waiver; thus, the court divided the benefit equally between them on his death.[8]

The Court of Appeals for the Fourth Circuit found that a valid waiver was executed where the separation agreement specified the plan in which the interest was waived, even though the ex-spouse was still named as beneficiary.[9]

A plan is not required to permit a waiver of the QJSA or QPSA form of benefit if it fully subsidizes the cost of such benefit and does not permit a participant to waive the benefit or designate another beneficiary. A plan fully subsidizes the cost of a benefit if the failure to waive the benefit would not result in a decrease of any plan benefits to the waiving participant and would not result in increased contributions from that participant.[10]

1. See *Lasche v. George W. Lasche Basic Profit Sharing Plan*, 111 F.3d 863 (11th Cir. 1997).
2. *Profit Sharing Plan for Employees of Republic Fin. Services, Inc. v. MBank Dallas, N.A.*, 683 F. Supp. 592 (N.D. Tex. 1988). But see *United Parcel Service, Inc. v. Riley*, 532 N.Y.S.2d 473 (1988).
3. *Burns v. Orthotek, Inc. Employees' Pension Plan & Trust*, 657 F.3d 571 (7th Cir. 2011).
4. *Kifafi v. Hilton Hotels Ret. Plan*, 826 F. Supp. 2d 25 (D.D.C. 2011).
5. Treas. Reg. §1.401(a)-20, A-28; *Hurwitz v. Sher*, 982 F.2d 778 (2d Cir. 1992), *cert. denied*, 113 S.Ct. 2345; *Nellis v. Boeing*, 1992 U.S. Dist. Lexis 8510 (D.C. Kan. 1992).
6. See also, *Pedro Enter., Inc. v. Perdue*, 998 F.2d 491 (7th Cir. 1993).
7. See *Hagwood v. Newton*, 282 F.3d 285 (4th Cir. 2002).
8. *National Auto. Dealers and Assoc. Retirement Trust v. Arbeitman*, 89 F.3d 496 (8th Cir. 1996).
9. *Estate of Altobelli v. IBM*, 77 F.3d 78 (4th Cir. 1996), overruled in part by *Kennedy v. Plan Administrator for DuPont Savings & Inv. Plan*, 555 U.S. 285 (2009).
10. IRC Sec. 417(a)(5).

Applicable Election Period

With respect to the QJSA form of benefit, the applicable election period is the 180 day period ending on the annuity starting date (the ninety day period, in the case of plan years beginning before 2007).[1] The plan generally may not commence the distribution of any portion of a participant's accrued benefit to which these requirements apply unless the applicable consent requirements are satisfied.[2]

A plan must provide participants with written notice of the QJSA requirement no less than thirty days and no more than 180 days (ninety days for plan years prior to 2007) before the annuity starting date.[3] If a participant, after receiving the written explanation of the QJSA, affirmatively elects a form of distribution with spousal consent, the plan will not fail to satisfy the requirements of IRC Section 417(a) merely because the annuity starting date is less than thirty days after the written explanation was provided to the participant, provided four requirements are met:

(1) the plan administrator must provide information to the participant clearly indicating that the participant has a right to at least thirty days to consider whether to waive the QJSA and consent to another form of distribution;

(2) the participant must be permitted to revoke an affirmative distribution election at least until the annuity starting date, or, if later, at any time prior to the expiration of the seven day period that begins the day the explanation of the QJSA is provided to the participant;

(3) the annuity starting date must be after the date the explanation of the QJSA is provided, except as provided in IRC Section 417(a)(7) (Q 3792); and

(4) distribution in accordance with the affirmative election must not begin before the expiration of the seven day period that begins the day the explanation of the QJSA is provided to the participant.[4]

With respect to the QPSA form of benefit, the applicable election period begins on the first day of the plan year in which the participant attains age thirty-five and ends on the date of his or her death. Where a participant has separated from service with the employer, the election period with respect to previously accrued benefits may begin no later than the date of separation.[5]

The applicable election period may not end before the thirtieth day after the plan provides the explanation required under IRC Section 417(a)(3).[6] Under that rule, a plan generally must, within certain specified periods, provide each participant (vested and non-vested,

1. See IRC Sec. 417(a)(6)(A).
2. Treas. Reg. §1.417(e)-1(b)(1).
3. See Treas. Reg. §1.417(e)-1(b)(3); IRC Sec 417(a)(6)(A).
4. Treas. Reg. §1.417(e)-1(b)(3)(ii).
5. IRC Sec. 417(a)(6)(B).
6. See Treas. Reg. §1.417(e)-1(b)(3)(ii).

married or unmarried) with a written explanation of the automatic survivor annuity forms of benefit and of the participant's (and his or her spouse's) rights with respect to waiving the benefits (Q 3792).

Required Minimum Distributions

3801. What is the latest date that benefits under a qualified plan can be paid?

A qualified plan must meet two separate sets of rules with regard to commencement of benefits: (i) The plan cannot delay the payment of benefits to a date beyond that which is set by statute, and (ii) the plan must meet the minimum distribution requirements of the Code. (See Q 3802 to Q 3812). As to the first element of this rule, a plan must provide that, unless a participant elects otherwise, payments of benefits to the participant will begin within sixty days after the close of the latest of (1) the plan year in which the participant attains the earlier of age sixty five or the normal retirement age specified under the plan, (2) the plan year in which the tenth anniversary of the participant's plan participation occurs, or (3) the plan year in which the participant terminates his or her service with the employer.[1]

A qualified plan also must meet the minimum distribution requirements set forth at IRC Section 401(a)(9) (Q 3802 to Q 3812).

TEFRA 242(b)(2) Election

Notwithstanding the general requirements above, the plan may be subject to a grandfathered TEFRA Section 242(b)(2) election. This election was permitted at the time the minimum distribution requirements of Section 401(a)(9) were enacted. Basically, a participant is not subject to the minimum distribution requirements if the participant designated, before January 1, 1984, a method of distribution that would have been permissible under pre-TEFRA law.[2] The final regulations stated that the transitional election rule in TEFRA Section 242(b)(2) was preserved and that a plan will not be disqualified merely because it pays benefits in accordance with this election. The plan must provide for the continuation of the election when it is restated or the election is lost.

3802. What are the minimum distribution requirements for qualified plans?

To be qualified, a plan must meet the statutory rules of IRC Section 401(a)(9), including the incidental death benefit requirement in IRC Section 401(a)(9)(G). The plan must also provide that distributions will be made in accordance with the minimum distribution requirements set forth in IRS regulations, as explained below. In addition, a qualified plan must provide that the minimum distribution rules override any distribution options offered under the plan that are inconsistent with these requirements.[3]

1. IRC Sec. 401(a)(14).
2. TEFRA, Sec. 242(b)(2); TRA '84, Sec. 521(d)(3).
3. IRC Sec. 401(a)(9); Treas. Reg. §1.401(a)(9)-1, A-3(a).

Regulations govern all issues except annuity distributions from defined benefit plans, which were addressed by regulations finalized in 2004 (Q 3805).[1] Regulations make governmental plans subject only to a "reasonable, good faith interpretation" of the minimum distribution requirements.[2]

Unless otherwise noted, the questions that follow explain the rules set forth in the final regulations. The regulations themselves are complex, and should be reviewed carefully with respect to any specific case, including with respect to the required beginning date (Q 3803), the minimum distribution requirements from individual accounts during the employee's lifetime (Q 3804), annuity payouts from defined benefit plans (Q 3805), after-death distribution requirements (Q 3806), designated beneficiaries (Q 3809), and the effect of a qualified domestic relations order on required distributions (Q 3812).

Failure to make minimum distributions. Although a plan that fails to meet the minimum distribution requirements with respect to all required distributions is technically subject to disqualification, the preamble to the 2001 proposed regulations state that such failures can be corrected through the Employee Plans Compliance Resolution System ("EPCRS").[3]

In addition to the qualification implications, if an amount distributed from a plan is less than the required minimum distribution (RMD), an excise tax equal to 50 percent of the shortfall generally is levied against the individual (Q 3813).[4] The tax may be waived if the payee establishes to the satisfaction of the IRS that the shortfall is due to reasonable error and that reasonable steps are being taken to remedy the shortfall.[5] The excise tax will be waived automatically if the beneficiary is an individual whose minimum distribution amount is determined under the life expectancy rule for after-death distributions, and the entire benefit to which that beneficiary is entitled is distributed under the five year rule.[6]

Planning Point: WRERA 2008 provided that RMDs from defined contribution plans and IRAs for calendar year 2009 are waived. Also, the five year rule is determined without regard to 2009. A person who received an RMD for 2009, including a distribution for 2009 made as late as April 1, 2010, had until the later of sixty days of receiving the RMD or November 30, 2009, to roll over the RMD to an IRA or other retirement plan (assuming the rollover would otherwise qualify).[7]

The minimum distribution requirements will not be treated as violated and, thus, the 50 percent excise tax will not apply where a shortfall occurs because assets are invested in a contract issued by an insurance company in state insurer delinquency proceedings. To the extent that a distribution otherwise required under IRC Section 401(a)(9) is not made during the state insurer delinquency proceedings, this amount and any additional amount accrued during this period will be treated as though it is not vested.[8]

1. Treas. Reg. §1.401(a)(9)-6.
2. Treas. Reg. §1.401(a)(9)-1, A-2(d).
3. See Rev. Proc. 2006-27, 2006-22 IRB 945, modified and superseded by Rev. Proc. 2008-50, 2008-35 IRB and Rev. Rul. 2013-12, 2013-1 CB 313.
4. IRC Sec. 4974.
5. Treas. Reg. §54.4974-2, A-7(a).
6. Treas. Reg. §54.4974-2, A-7(b).
7. Notice 2009-82, 2009-41 IRB 491.
8. Treas. Reg. §1.401(a)(9)-8, A-8.

3803. What is the required beginning date for required minimum distributions from a qualified plan?

In order to be qualified, a plan must provide that the entire interest of each employee will be distributed not later than his required beginning date, or will be distributed beginning not later than the required beginning date over certain prescribed time periods.[1]

For purposes of the minimum distribution rules (Q 3802 to Q 3812) and the minimum distribution incidental benefit rule (Q 3813), the term required beginning date means April 1 of the calendar year following the later of the year in which the employee attains age 70½ or the year in which the employee (other than a 5 percent owner) retires from the employer maintaining the plan.[2]

In the case of a 5 percent owner, required beginning date means April 1 of the calendar year following the year in which the employee attains age 70½.[3] The IRS determined that where a 5 percent owner rolls over the account balance to the plan of another employer in which the 5 percent owner was not a 5 percent owner (after receiving the required distribution for the year in question), the individual could delay distributions from the new plan until retiring after age 70½.[4]

A plan is permitted to provide that the required beginning date for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 70½ regardless of whether the employee is a 5 percent owner.[5]

If distributions began irrevocably (except for acceleration) prior to the required beginning date in the form of an annuity that meets the minimum distribution rules, the annuity starting date will be treated as the required beginning date for purposes of calculating lifetime and after death minimum distribution requirements (Q 3805).[6]

If, for example, an employee's date of birth was June 30, 1939, the employee would reach age 70 on June 30, 2009, and would reach age 70½ on December 30, 2009. Consequently, assuming the employee is retired or a 5 percent owner, the employee's required beginning date would be April 1, 2010. Because distributions from a defined contribution plan are waived for 2009, a distribution from a defined contribution plan would not be required until December 31, 2010. If the same employee's birthday were July 1, 1942, the employee would reach age 70½ on January 1, 2013, and the employee's required beginning date would be April 1, 2014.[7]

1. IRC Sec. 401(a)(9)(A).
2. IRC Sec. 401(a)(9)(C).
3. IRC Sec. 401(a)(9)(C)(ii)(I).
4. Let. Rul. 200453015.
5. Treas. Reg. §1.401(a)(9)-2, A-2(e).
6. Treas. Reg. §1.401(a)(9)-6, A-10.
7. Treas. Reg. §1.401(a)(9)-2, A-3; Notice 2009-82; 2009-2 C.B. 491.

3804. What minimum distribution requirements apply to individual account plans during the lifetime of the employee?

To satisfy IRC Section 401(a)(9)(A), the entire interest of each employee either must be distributed to the employee in its entirety not later than the required beginning date or must be distributed starting not later than the required beginning date over the life (or life expectancy) of the employee (or the employee and a beneficiary).[1]

Planning Point: RMDs were waived for 2009. A distribution for 2009 required to be made by December 31, 2009 could be waived. A distribution for 2009 required to be made by a beginning date of April 1, 2010 could also be waived. But a distribution for 2008 that was made by a beginning date of April 1, 2009 could not be waived.

Uniform Lifetime Table. Required minimum distributions from an individual account under a defined contribution plan during the owner's lifetime are calculated by dividing the employee's account balance by the applicable distribution period determined from the RMD Uniform Lifetime Table found in Appendix F.[2] For an example showing the calculation under this rule, see Q 3637. The amount of an individual's lifetime required distribution is calculated without respect to the beneficiary's age, except in the case of a spouse beneficiary who is more than ten years younger than the employee.[3]

If the sole designated beneficiary is the employee's spouse, the distribution period during the employee's lifetime is the longer of the uniform lifetime table or the joint and survivor life expectancy of the employee and spouse using their attained ages in the distribution calendar year.[4] As a practical matter, the joint and survivor life expectancy table will produce a longer (and thus, lower) payout only if the spouse beneficiary is more than ten years younger than the employee.

Account balance. For purposes of calculating minimum distributions, the account balance is determined as of the last valuation date in the immediately preceding calendar year (i.e., the valuation calendar year).[5] The account balance is increased by the amount of any contributions or forfeitures allocated to the employee's account as of dates in the valuation calendar year after the valuation date. Contributions include contributions made after the close of the valuation calendar year that are allocated as of a date in the valuation calendar year.[6] The account balance is decreased by any distributions made during the valuation calendar year, after the valuation date.[7] The account balance does not include the value of a qualifying longevity annuity contract purchased after July 2, 2014.[8]

1. IRC Sec. 401(a)(9)(A).
2. Treas. Reg. §1.401(a)(9)-9, A-2.
3. Treas. Reg. §1.401(a)(9)-5, A-4.
4. Treas. Reg. §1.401(a)(9)-5, A-4(b).
5. Treas. Reg. §1.401(a)(9)-5, A-3(a).
6. Treas. Reg. §1.401(a)(9)-5, A-3(b).
7. Treas. Reg. §1.401(a)(9)-5, A-3(c)(1).
8. Treas. Reg. §1.401(a)(9)-5, A-3(d). See Treas. Reg. §1.401(a)(9)-6, A-17 for definition of QLAC.

Employee not fully vested. If a portion of an employee's individual account is not vested as of the employee's required beginning date, the benefit used to calculate the required minimum distribution for any year is determined without regard to whether all of the benefit is vested, and distributions will be treated as being paid from the vested portion of the benefit first. If the required minimum distribution amount is greater than the vested benefit, only the vested portion is required to be distributed.[1] In any event, the required minimum distribution amount will never exceed the entire vested account balance on the date of distribution.[2] The required minimum distribution for subsequent years, however, must be increased by the sum of amounts not distributed in prior calendar years because the employee's vested benefit was less than the required minimum distribution amount.[3]

Distributions made prior to an individual's required beginning date are not subject to these rules. If distributions begin under a distribution option, such as an annuity, that provides for payments after the individual's required beginning date, distributions that will be made under the option on and after that date must satisfy these rules or the entire option fails from the beginning.[4]

Distributions in excess of the amounts required under these rules do not reduce the amount required in subsequent years.[5] Rollovers and transfers among plans during years in which distributions are required under these rules can have a significant effect on the application of the minimum distribution rules.[6] For rules that apply to distributions when a QDRO is in effect, see Q 3812. Rules pertaining to separate accounts or segregated shares under a single plan, to employees participating in more than one plan, and other special rules affecting the application of the minimum distribution requirements are set forth in Treasury Regulation Section 1.401(a)(9)-8.

Distributions made in accordance with the provisions set forth in Treasury Regulation Section 1.401(a)(9)-5, as explained above, will satisfy the minimum distribution incidental benefit requirement (Q 3813).[7]

3805. What minimum distribution requirements apply to annuity payouts from a defined benefit plan?

Annuity distributions from a defined benefit plan must be paid in periodic payments at least annually for the employee's life (or for the joint lives of an employee and beneficiary), or over a period certain that is not longer than the life expectancy (or joint and survivor life expectancy) of the employee (or the employee and a beneficiary), as set forth in the IRC's provisions for lifetime and after death distributions.[8] The annuity also may be a life annuity (or joint and

1. Treas. Reg. §1.401(a)(9)-5, A-8.
2. Treas. Reg. §1.401(a)(9)-5, A-1(a).
3. Treas. Reg. §1.401(a)(9)-5, A-8.
4. Treas. Reg. §1.401(a)(9)-2, A-4.
5. Treas. Reg. §1.401(a)(9)-5, A-2.
6. Treas. Reg. §1.401(a)(9)-7.
7. Treas. Reg. §1.401(a)(9)-5, A-1(d). Under the proposed rules, (d) becomes (e).
8. Treas. Regs. §§1.401(a)(9)-6, A-1(a); 1.401(a)(9)-6, A-3; see IRC Sec. 401(a)(9)(A).

survivor annuity) with a period certain, as long as the life (or lives) and period certain each meet the foregoing requirements.[1]

Regulations state that qualifying longevity annuity distributions from defined benefit plans must meet new requirements in 1.401(a)(9)-6, A-17(b) and (d)(1) rather than the rules in 1.408-8, A-12(b) and (c).[2]

Regulations set forth requirements that annuity distributions under a defined benefit plan must meet to satisfy IRC Section 401(a)(9)(A).[3] Although the regulations do not address annuity distributions from defined contribution plans, the IRS has ruled privately that a fixed or variable annuity could be used to satisfy the minimum distribution requirements from a profit sharing or money purchase plan.[4]

Distributions from an annuity contract must commence on or before the employee's required beginning date. The first payment must be the payment that is required for one payment interval. The second payment need not be made until the end of the next payment interval, even if the interval ends in the next calendar year.[5] Examples of payment intervals include monthly, bimonthly, semi-annually, and annually. All benefit accruals as of the last day of the first distribution calendar year must be included in the calculation of the amount of the life annuity payments for payment intervals ending on or after the employee's required beginning date.[6]

Period Certain Limits

The period certain for annuity distributions commencing during the life of an employee, with an annuity starting date on or after the required beginning date, may not exceed the amount set forth in the Uniform Lifetime Table in Appendix F. If an employee's spouse is the sole beneficiary as of the annuity starting date and the annuity provides only a period certain and no life annuity, the period certain may be as long as the joint and survivor life expectancy of the employee and spouse based on their ages as of their birthdays in the calendar year that contains the annuity starting date.[7]

Employee Not Fully Vested

If any portion of an employee's benefit is not fully vested as of his or her required beginning date, the employee's required minimum distribution will be calculated as though the portion that is not vested has not yet accrued. As additional vesting occurs, the amounts will be treated as additional accruals.[8] If additional benefits accrue after the participant's

1. Treas. Reg. §1.401(a)(9)-6, A-1(b).
2. 79 FR 37633.
3. TD 9130, 2004-26 IRB 1082.
4. Let. Rul. 200635013.
5. Treas. Reg. §1.401(a)(9)-6, A-1(c).
6. Treas. Reg. §1.401(a)(9)-6, A-1(c)(1).
7. Treas. Reg. §1.401(a)(9)-6, A-3(a).
8. Treas. Reg. §1.401(a)(9)-6, A-6.

required beginning date, the amounts will be treated separately for purposes of the minimum distribution rules.[1]

Actuarial Increase Requirement

If an employee other than a 5 percent owner retires after the calendar year the employee reaches age 70½, a defined benefit plan actuarially must increase the employee's accrued benefit to take into account any period after age 70½ during which the employee was not receiving benefits under the plan.[2] The increase must be provided starting on April 1 of the year after the employee reaches age 70½ and ending on the date when required minimum distributions commence in an amount sufficient to satisfy IRC requirements.[3] This actuarial increase requirement does not apply to (1) plans that provide the same required beginning date (i.e., April 1 of the year after the employee reaches age 70½) for all employees, regardless of whether they are 5 percent owners and make distributions accordingly, or (2) governmental or church plans.[4]

Non-increasing Annuity Requirement

Except as otherwise provided (see below), annuity payments must be non-increasing, or must increase only:

(1) in accordance with an annual percentage not exceeding that of an eligible cost-of-living index (e.g., one issued by the Bureau of Labor Statistics or certain others defined in the regulations);

(2) in accordance with a percentage increase that occurs at specified times (e.g., at specified ages) and does not exceed the cumulative total of annual percentage increases in an eligible cost of living index (see (1)) since the annuity starting date;

(3) in accordance with the extent of the reduction in the amount of the employee's payments to provide for a survivor benefit upon death (if the beneficiary dies or is no longer subject to a QDRO);

(4) in accordance with a plan amendment; or

(5) to allow a beneficiary to convert the survivor portion of a joint and survivor annuity into a single sum distribution upon the employee's death.[5]

Additional Permitted Increases

If the total future expected payments from an annuity purchased from an insurance company exceed the total value being annuitized, payments under the annuity will not fail to satisfy the

1. Treas. Reg. §1.401(a)(9)-6, A-5.
2. IRC Sec. 401(a)(9)(C)(ii).
3. Treas. Reg. §1.401(a)(9)-6, A-7(a).
4. Treas. Regs. §§1.401(a)(9)-6, A-7(c), 1.401(a)(9)-6, A-7(d).
5. Treas. Reg. §1.401(a)(9)-6, A-14(a).

non-increasing payment requirement merely because the payments are increased in accordance with one or more of the following:

(1) by a constant percentage, applied not less frequently than annually;

(2) to provide a final payment on the employee's death that does not exceed the excess of the total value being annuitized over the total of payments before the death of the employee;

(3) as a result of dividend payments or other payments resulting from certain actuarial gains; and

(4) an acceleration of payments under the annuity (as defined in the regulations).[1]

In the case of annuity payments paid under a qualified defined benefit plan (i.e., paid directly from the trust rather than a commercial annuity), payments will not fail to satisfy the non-increasing payment requirement merely because the payments are increased in accordance with one or more of the following: (1) by a constant percentage, applied not less frequently than annually, at a rate that is less than 5 percent per year; (2) to provide a final payment on the death of the employee that does not exceed the excess of the actuarial present value of the employee's accrued benefit (as defined in the regulations) over the total of payments before the death of the employee; or (3) as a result of dividend payments or other payments resulting from actuarial gain (measured and paid as specified in the regulations).[2]

An annuity contract purchased with an employee's benefit by the plan from an insurance company will not fail to satisfy the rules of Section 401(a)(9) merely because of the purchase, provided the payments meet the foregoing requirements.[3] If the annuity contract is purchased after the required beginning date, the first payment interval must begin on or before the purchase date and the payment amount required for one interval must be made no later than the end of that payment interval.[4]

Changes in Form of Distribution

In addition to the foregoing permitted increases, the final regulations permit the employee or beneficiary to change the form of distributions in response to various changes in circumstances. The annuity stream must otherwise satisfy the regulations, and certain other requirements must be met (e.g., the new payout must satisfy IRC Section 401(a)(9)) and the modification must be treated as a new annuity starting date under Sections 415 and 417.[5]

If these conditions are met, the annuity payment period may be changed and the payments may be modified if: (1) the modification occurs at the time the employee retires, or in connection with a plan termination, (2) the annuity payments prior to modification are annuity payments

1. Treas. Regs. §§1.401(a)(9)-6, A-14(c), 1.401(a)(9)-6, A-14(e).
2. Treas. Regs. §§1.401(a)(9)-6, A-14(d), 1.401(a)(9)-6, A-14(e).
3. Treas. Reg. §1.401(a)(9)-6, A-4.
4. Treas. Reg. §1.401(a)(9)-6, A-4.
5. Treas. Reg. §1.401(a)(9)-6, A-13(c).

paid over a period certain without life contingencies, or (3) the employee gets married and the annuity payments after modification are paid under a qualified joint and survivor annuity over the joint lives of the employee and spouse.[1]

Payments to Children

Payments under a defined benefit plan or annuity contract that are made to an employee's surviving child[2] until the child reaches the age of majority may be treated (for required minimum distribution purposes) as having been paid to the surviving spouse, provided that they are payable to the surviving spouse once the child reaches the age of majority. For this purpose, a child under age twenty-six who has not completed "a specified course of education" may be treated as not having reached the age of majority.

Furthermore, a child who is disabled may be treated as not having reached the age of majority as long as the child continues to be disabled. The child will not be taken into consideration for purposes of the Minimum Distribution Incidental Benefit (MDIB) requirement and the increase in payments to the surviving spouse that results when the child recovers or reaches the age of majority will not be considered an increase for purposes of the non-increasing annuity requirement.[3]

Special Rules

The distribution of an annuity contract is not a distribution for purposes of meeting the required minimum distribution requirements of IRC Section 401(a)(9).[4] If the employee's entire accrued benefit is paid in the form of a lump sum distribution, the portion that is a required minimum distribution will be determined by treating the distribution either as if it were from an individual account plan (Q 3804) or as if it were an annuity that would satisfy the regulations with an annuity starting date on the first day of the distribution calendar year for which the required minimum distribution is being determined, and one year of annuity payments constitutes the required minimum distribution.[5]

In the case of an annuity contract under an individual account plan that has not yet been annuitized, the required minimum distribution for the period prior to the date annuity payments commence is determined by treating the value of an employee's entire interest under an annuity contract as an individual account. Thus, the required minimum distribution would be determined under Treasury Regulation Section 1.401(a)(9)-5; for the rules for individual account plans, see Q 3804.

Regulations making governmental plans subject to only a "reasonable, good faith interpretation" of the minimum distribution requirements under Section 401(a)(9) have been adopted.[6]

1. Treas. Reg. §1.401(a)(9)-6, A-13(b).
2. Pursuant to IRC Sec. 401(a)(9)(F).
3. Treas. Reg. §1.401(a)(9)-6, A-15.
4. Treas. Reg. §1.401(a)(9)-8, A-10.
5. Treas. Reg. §1.401(a)(9)-6, A-1(d). [Would be (e) after proposed rule becomes effective].
6. 1.401(a)(9)-1, A-2(d), 1.401(a)(9)-6, A-16, as amended, 1.401(a)(9)-6(e)(8).

3806. How are the minimum distribution requirements met after the death of an employee?

The minimum distribution requirements that apply after the death of an employee depend on whether the employee died before (Q 3807) or after (Q 3808) his or her required beginning date. For this purpose, distributions are treated as having begun in accordance with the minimum distribution requirements under IRC Section 401(a)(9)(A)(ii) without regard to whether payments have been made before that date.[1]

If distributions irrevocably (except for acceleration) began prior to the required beginning date in the form of an annuity that satisfies the minimum distribution rules (Q 3805), the annuity starting date will be treated as the required beginning date (Q 3803) for purposes of calculating lifetime and after death minimum distribution requirements.[2] For details on the ability of a non-spouse designated beneficiary to rollover funds from a qualified plan account to an inherited IRA, see Q 3893.

Planning Point: RMDs were waived for 2009.[3] A distribution for 2009 required to be made by December 31, 2009 could be waived. A distribution in the year after death that would ordinarily be required by the end of 2009 was not required until the end of 2010.

3807. How are the minimum distribution requirements met after the death of an employee who died before the required beginning date?

If an employee dies before his or her required beginning date, distributions must be made under one of two methods:

(1) Under the life expectancy rule, if any portion of the interest is payable to, or for the benefit of, a designated beneficiary, that portion must be distributed over the life (or life expectancy) of the beneficiary, beginning within one year of the employee's death.[4]

To the extent that the interest is payable to a non-spouse beneficiary, distributions must begin by the end of the calendar year immediately following the calendar year in which the employee died.[5] The non-spouse beneficiary's life expectancy for this purpose is measured as of his or her birthday in the year following the year of the employee's death. In subsequent years, this amount is reduced by one for each calendar year that has elapsed since the year immediately following the year of the employee's death.[6]

(2) Under the five year rule, if there is no designated beneficiary, or if the foregoing rule is not satisfied, the entire interest must be distributed within five years after the

1. Treas. Reg. §1.401(a)(9)-2, A-6(a).
2. Treas. Reg. §1.401(a)(9)-6, A-10, A-11.
3. Notice 2009-82, 2009-2 C.B. 491.
4. IRC Sec. 401(a)(9)(B)(iii); Treas. Reg. §1.401(a)(9)-3, A-1(a).
5. Treas. Reg. §1.401(a)(9)-3, A-3(a).
6. Treas. Reg. §1.401(a)(9)-5, A-5(c)(1).

death of the employee (regardless of who or what entity receives the distribution).[1] To satisfy this rule, the entire interest must be distributed by the end of the calendar year that contains the fifth anniversary of the date of the employee's death.[2]

Planning Point: If 2009 is one of the five years, the five year period is expanded to six years.

Surviving spouse beneficiary. If the sole designated beneficiary is the employee's surviving spouse, distributions must begin by the later of the end of the calendar year immediately following the calendar year in which the employee died or the end of the calendar year in which the employee would have reached age 70½.[3]

In the event that a surviving spouse beneficiary dies after the employee, but before distributions to the spouse have begun, the five year rule and the life expectancy rule for surviving spouses will be applied as though the surviving spouse were the employee.[4] The payout period during the surviving spouse's life is measured by the surviving spouse's life expectancy as of his or her birthday in each distribution calendar year for which a minimum distribution is required after the year of the employee's death.[5] The provision that treats a surviving spouse as though the surviving spouse were the employee (i.e., the surviving spouse rules of IRC Section 401(a)(9)(B)(iv)) will not allow a new spouse of the deceased employee's spouse to continue delaying distributions.[6]

Life expectancy tables. There are tables with single and joint and survivor life expectancies for calculating required minimum distributions, as well as a "Uniform Lifetime Table," for determining the appropriate distribution periods.[7] See Appendix F.

Plan provisions. Unless a plan adopts a provision specifying otherwise, if distributions to an employee have not begun prior to his or her death, they must be made automatically either under the life expectancy rule described above or, if there is no designated beneficiary, under the five year rule.[8] A plan may adopt a provision specifying that the five year rule will apply after the death of an employee, or a provision allowing employees (or beneficiaries) to elect whether the five year rule or the life expectancy rule will be applied.[9]

3808. How are the minimum distribution requirements met after the death of an employee who died on or after the required beginning date?

The entire remaining balance generally must be distributed at least as rapidly as under the method of distribution in effect as of an employee's date of death.[10] If an employee dies after distributions have begun, (i.e., generally on or after his or her required beginning date), but

1. IRC Sec. 401(a)(9)(B)(ii), Treas. Reg. §1.401(a)(9)-3, A-1(a).
2. Treas. Reg. §1.401(a)(9)-3, A-2.
3. IRC Sec. 401(a)(9)(B)(iv); Treas. Reg. §1.401(a)(9)-3, A-3(b).
4. IRC Sec. 401(a)(9)(B)(iv)(II); Treas. Reg. §1.401(a)(9)-3, A-5.
5. Treas. Reg. §1.401(a)(9)-5, A-5(c)(2).
6. Treas. Reg. §1.401(a)(9)-3, A-5.
7. Treas. Reg. §1.401(a)(9)-9.
8. Treas. Regs. §§1.401(a)(9)-1, A-3(c), 1.401(a)(9)-3, A-4(a).
9. Treas. Regs. §§1.401(a)(9)-3, A-4(b), 1.401(a)(9)-3, A-4(c).
10. IRC Sec. 401(a)(9)(B)(i).

before the employee's entire interest in the plan has been distributed, the method of distribution will depend on whether the distribution was in the form of distributions from an individual account under a defined contribution plan or annuity payments from a defined benefit plan.[1] If the distributions are annuity payments from a defined benefit plan, they will be determined as explained in Q 3805.

The beneficiary must be determined as of September 30 of the year after the year of the employee's death.[2] In the case of an individual account plan, if the employee does not have a "designated beneficiary" (Q 3809) as of that date, the employee's interest is distributed over the employee's remaining life expectancy, using the age of the employee in the calendar year of his or her death, reduced by one for each calendar year that elapses thereafter.[3]

If the employee does have a designated beneficiary as of the determination date, the beneficiary's interest is distributed over the longer of the beneficiary's life expectancy, calculated as described above under the life expectancy rule[4] or the remaining life expectancy of the employee determined using the age of the employee in the calendar year of his or her death, reduced by one for each calendar year that elapses thereafter.[5]

3809. How is the designated beneficiary determined for purposes of the minimum distribution requirements?

A designated beneficiary means any individual designated as a beneficiary by the employee.[6] An individual may be designated as a beneficiary under a plan either by the terms of the plan or, if the plan so provides, by an affirmative election by the employee (or the employee's surviving spouse) specifying the beneficiary.[7]

The fact that an employee's interest under a plan passes to a certain individual under applicable state law, however, does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan.[8] For details on the ability of a non-spouse designated beneficiary to rollover funds from a qualified plan account to an inherited IRA, see Q 3893.

A beneficiary designated under a plan is an individual (or certain trusts (see below)) who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event. A designated beneficiary need not be specified by name in the plan or by the employee to the plan to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan as of the date the beneficiary is determined.

Planning Point: To be a QDRO, the beneficiary should be named or otherwise be clearly identified.

1. Treas. Reg. §1.401(a)(9)-2, A-5.
2. Treas. Reg. §1.401(a)(9)-4, A-4(a).
3. Treas. Reg. §1.401(a)(9)-5, A-5(c)(3).
4. Treas. Reg. §1.401(a)(9)-5, A-5(c)(1) or (2).
5. Treas. Regs. §§1.401(a)(9)-5, A-5(c)(3), 1.401(a)(9)-5, A-5(a)(1).
6. IRC Sec. 401(a)(9)(E).
7. Treas. Reg. §1.401(a)(9)-4, A-1.
8. Treas. Reg. §1.401(a)(9)-4, A-1. See e.g. *Kennedy v. Plan Adm'r for DuPont Sav. & Inv. Plan*, 555 U.S. 285 (2009).

The choice of beneficiary is subject to the IRC's provisions for joint and survivor annuities, QDROs, and consent requirements (Q 3792, Q 3800, Q 3816).[1] For an explanation of the effect of a QDRO on the minimum distribution requirements, see Q 3812.

To be a designated beneficiary for purposes of minimum distributions, an individual must be a beneficiary on the date of the employee's death. The determination of the existence and identity of a designated beneficiary for purposes of minimum distributions is made on September 30 of the calendar year following the year of the employee's death.[2] Exceptions may apply if the account is payable as an annuity, or if a surviving spouse beneficiary dies after the employee but before distributions have begun. This is so a distribution may be calculated and made by the deadline of December 31 following the year of the employee's death.

Consequently, an individual who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of September 30 of the following year (e.g., because the individual disclaims entitlement to the benefit or because the individual receives the entire benefit to which he or she is entitled before that date) is not taken into account for purposes of determining the distribution period for required minimum distributions after the employee's death.[3]

A disclaiming beneficiary's receipt (prior to disclaiming the benefit) of a required distribution in the year after death will not result in the beneficiary being treated as a designated beneficiary for subsequent years.[4]

An entity other than an individual or a trust meeting certain requirements (see Q 3811) cannot be a designated beneficiary for required minimum distribution purposes. Thus, for example, an employee's estate cannot be a designated beneficiary.[5]

Multiple Beneficiaries

If more than one beneficiary is designated with respect to an employee as of the date on which the designated beneficiary is to be determined, the designated beneficiary with the shortest life expectancy is the measuring life for purposes of determining the distribution period.[6] Special rules, explained in Q 3810, apply if the employee's benefit is divided into separate accounts, or segregated shares, and the beneficiaries of each account differ.

If an employee has designated multiple beneficiaries, and as of the date on which the designated beneficiary is to be determined, one of the beneficiaries is an entity (such as a trust not meeting applicable requirements or a charitable organization), the employee will be treated as having no beneficiaries.[7]

1. Treas. Reg. §1.401(a)(9)-4, A-2.
2. Treas. Reg. §1.401(a)(9)-4, A-4(a).
3. Treas. Reg. §1.401(a)(9)-4, A-4(a).
4. Rev. Rul. 2005-36, 2005-26 IRB 1368; Let. Rul. 201125009; Let. Rul. 201245004.
5. Treas. Reg. §1.401(a)(9)-4, A-3.
6. Treas. Reg. §1.401(a)(9)-5, A-7(a)(1).
7. Treas. Reg. §1.401(a)(9)-4, A-3.

Contingent and Successor Beneficiaries

If a beneficiary's entitlement to an employee's benefit is contingent on an event other than the employee's death or the death of another beneficiary, the contingent beneficiary will be considered a designated beneficiary for purposes of determining the designated beneficiary who has the shortest life expectancy.[1] The fact that the contingency may be extremely remote (e.g., two children predeceasing a sixty-seven-year-old relative) does not appear to affect this outcome.[2]

In contrast, if a "successor beneficiary's" entitlement is contingent on the death of another beneficiary, the successor beneficiary's life expectancy cannot be counted for purposes of determining the designated beneficiary who has the shortest life expectancy unless the other beneficiary dies prior to the date on which the beneficiary is determined.[3]

3810. What are the separate account rules for purposes of the minimum distribution requirements?

If an employee's benefit is divided into separate accounts under a defined contribution plan (or in the case of a defined benefit plan, into segregated shares) and the separate accounts have different beneficiaries, the accounts do not have to be aggregated for purposes of determining the required minimum distributions for years subsequent to the calendar year in which they were established (or date of death, if later).[4] Separate account treatment is permitted for the year following the year of death, provided the separate accounts are actually established by the end of the calendar year following death.

For purposes of Section 401(a)(9), separate accounts are portions of an employee's benefit representing the separate interests of the employee's beneficiaries under the plan as of the employee's date of death. The separate accounting must allocate all post-death investment gains and losses, contributions, and forfeitures for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner among the accounts.

Once separate accounts actually are established, the separate accounting can provide for separate investments in each account, with gains and losses attributable to such investments allocable only to that account. A separate accounting also must allocate any post-death distribution to the separate account of the beneficiary receiving it.[5]

The applicable distribution period is determined for each separate account disregarding the other beneficiaries (i.e., allowing each beneficiary to use his or her own life expectancy) only if the separate account is established no later than December 31 of the year following the decedent's death.[6]

1. Treas. Reg. §1.401(a)(9)-5, A-7(b).
2. See Let. Rul. 200228025.
3. Treas. Reg. §1.401(a)(9)-5, A-7(c)(1).
4. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).
5. Treas. Reg. §1.401(a)(9)-8, A-3.
6. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).

If a trust is the beneficiary of an employee's plan interest, separate account treatment is not available to the beneficiaries of the trust.[1] The IRS has determined repeatedly that the establishment of separate shares did not entitle multiple beneficiaries of the same trust to use their own life expectancies as the distribution period.[2] The IRS has privately ruled that where separate individual trusts were named as beneficiaries, the ability of each beneficiary to use his or her life expectancy was preserved even though the trusts were governed by a single "master trust."[3]

If the December 31 deadline is missed, or if the plan beneficiary is a trust with multiple beneficiaries, separate accounts still may be established (e.g., for administrative convenience); however, the applicable distribution period will be the shortest life expectancy of the various beneficiaries.[4] The fact that the trust meets the requirements for a "see-through trust" does not change this result.[5]

3811. When may a trust be a designated beneficiary for purposes of the minimum distribution requirements?

As a general rule, only an individual may be a designated beneficiary for required minimum distribution purposes. If special requirements are met, however, beneficiaries of a trust may be treated as having been designated as beneficiaries of the employee under the plan for required minimum distribution purposes.

During any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee, the requirements will be met if:

(1) the trust is a valid trust under state law, or would be but for the fact that there is no corpus;

(2) the trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee;

(3) the beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument, as described below; and

(4) the documentation described below has been provided to the plan administrator.[6]

A trust that satisfies these requirements is sometimes referred to as a "see-through trust."

The IRS has privately ruled that a see-through trust's provision for payment of expenses such as funeral and burial costs, probate administration expenses, and estate costs, whether

1. Treas. Reg. §1.401(a)(9)-4, A-5(c).
2. See, e.g., Let. Ruls. 200307095, 200444033, 200528031.
3. See Let. Rul. 200537044.
4. Treas. Reg. §1.401(a)(9)-8, A-2(a)(2).
5. See Let. Rul. 200317044.
6. Treas. Reg. §1.401(a)(9)-4, A-5(b); Ltr. Rul. 201320021.

before or after September 30 of the year after the decedent's death, did not preclude the trust from meeting the foregoing requirements.[1]

A designated beneficiary need not be specified by name in a plan or by an employee to a plan to be a designated beneficiary, so long as the individual who is to be the beneficiary is identifiable under the plan as of the date the beneficiary is determined (see above). The members of a class of beneficiaries capable of expansion or contraction will be treated as identifiable if it is possible, as of the date the beneficiary is determined, to identify the class member with the shortest life expectancy.[2]

Documentation Requirements

To satisfy the documentation requirement for trust beneficiaries to be treated as designated beneficiaries for purposes of lifetime distributions, an employee must meet one of two requirements:

(1) the employee must provide to the plan administrator a copy of the trust and agree that if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide the plan administrator with a copy of any such amendment, or

(2) the employee must provide the plan administrator with a list of all the beneficiaries (including contingent and remainder beneficiaries, as well as a description of the conditions on their entitlement) of the trust. If the spouse is the sole beneficiary, a description of the conditions of the remainder beneficiaries' entitlement sufficient to establish that fact must be provided. The employee must certify that to the best of the employee's knowledge, the list is correct and complete, and that the other requirements for the beneficiaries of the trust to be treated as designated beneficiaries have been satisfied. The employee also must agree to provide a copy of the trust instrument on demand. In any event, if the trust is amended, the employee must provide a copy of any such amendment or provide a corrected certification to the extent that the amendment changes the information previously certified.[3]

After-death Distributions

To satisfy the documentation requirements for required minimum distributions after the death of an employee (or after the death of an employee's surviving spouse, if the spouse dies after the employee but before distributions have begun), the trustee must meet following requirements by October 31 of the calendar year after the year of the employee's death:

(1) the trustee must (x) provide the plan administrator with a final list of all the beneficiaries (including contingent and remainder beneficiaries, as well as

1. See Let. Rul. 200432027.
2. Treas. Reg. §1.401(a)(9)-4, A-1.
3. Treas. Reg. §1.401(a)(9)-4, A-6.

a description of the conditions on their entitlement) as of September 30 of the calendar year following the calendar year of the employee's death; (y) certify that to the best of the trustee's knowledge the list is correct and complete and that the trust meets the general requirements listed above for all trust beneficiaries; and (z) agree to provide a copy of the trust instrument to the plan administrator on demand; or

(2) the trustee must provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.[1]

If the foregoing requirements are met, a plan will not fail to satisfy Section 401(a)(9) merely because the actual terms of the trust instrument are inconsistent with the information in the certifications or trust instruments previously provided. This relief applies, however, only if the plan administrator reasonably relied on the information provided and the required minimum distributions for calendar years after the discrepancy is discovered are determined based on the actual terms of the trust instrument.[2] The actual trust terms will govern for purposes of determining the amount of any excise tax under Section 4974 (Q 3814).[3]

3812. Who is the employee's spouse or surviving spouse for purposes of the minimum distribution requirements? What is the effect of a QDRO?

For purposes of the minimum distribution requirements under IRC Section 401(a)(9), unless a qualified domestic relations order ("QDRO") is in effect (see below), an individual will be considered a spouse or surviving spouse of an employee if that individual is treated under applicable state law as the spouse or surviving spouse of the employee.

Planning Point: Since the federal Defense of Marriage Act was successfully challenged in front of the Supreme Court in the *Windsor* decision, same sex spouses now have the same rights as opposite sex spouses for purposes of these rules.

For purposes of the life expectancy rule applied after an employee's death, the spouse of the employee is determined as of the employee's date of death.[4]

If a portion of an employee's benefit is payable to a former spouse pursuant to a QDRO (Q 3816), the former spouse to whom the benefit is payable will be treated as a spouse or surviving spouse, as the case may be, of the employee for purposes of the minimum distribution and minimum distribution incidental benefit requirements.[5]

If a QDRO provides that an employee's benefit is to be divided and a portion is to be allocated to an alternate payee, that portion will be treated as a separate account or as a segregated share for purposes of satisfying the minimum distribution requirements. For example,

1. Treas. Reg. §1.401(a)(9)-4, A-6(b).
2. Treas. Reg. §1.401(a)(9)-4, A-6(c)(1).
3. Treas. Reg. §1.401(a)(9)-4, A-6(c)(2).
4. Treas. Reg. §1.401(a)(9)-8, A-5.
5. Treas. Reg. §1.401(a)(9)-8, A-6(a).

distributions from the account generally will satisfy IRC Section 401(a)(9) if required minimum distributions begin not later than the employee's required beginning date, using the rules for individual accounts.[1]

A distribution of a separate account allocated to an alternate payee will satisfy the lifetime distribution requirements if the distribution begins no later than the employee's required beginning date (Q 3803) and is made over the life or life expectancy of the payee.

Planning Point: Because of these rules, distributions to a child pursuant to a QDRO can be stretched out over a greater period than otherwise would be allowed under the minimum distribution rules to a spousal alternate payee.

If an alternate payee dies after distributions have begun but before the employee dies, distribution of the remaining portion of the benefit allocated to the alternate payee must be made in accordance with the lifetime distribution rules for individual accounts (Q 3804) or annuity payouts (Q 3805).[2]

If a QDRO provides that a portion of the employee's benefit is to be paid to an alternate payee but does not provide for the benefit to be divided, the alternate payee's portion will not be treated as a separate account (or segregated share) of the employee. Instead, the alternate payee's portion will be aggregated with any amount distributed to the employee and will be treated, for purposes of meeting the minimum distribution requirement, as if it had been distributed to the employee.[3]

A plan will not fail to satisfy IRC Section 401(a)(9) merely because it fails to distribute a required amount during the period in which the qualified status of a domestic relations order is being determined provided it does not extend beyond the eighteen-month period described in the IRC and ERISA. Any distributions delayed under this rule will be treated as though they had not been vested at the time distribution was required.[4]

3813. What is the incidental benefit rule for qualified plans?

Qualified retirement plans are required to be primarily for payment of retirement benefits, although certain other benefits (e.g., death benefits) may be provided through the "incidental benefit rule" or "incidental death benefit rule." This restriction commonly refers to two similar, but separate, rules.

One limits pre-retirement distributions in the form of nonretirement benefits such as life, accident, or health insurance (Q 3751).

The second is a rule more properly referred to as the "minimum distribution incidental benefit ("MDIB") rule." The purpose of the MDIB rule is to ensure that funds are accumulated

1. Treas. Reg. §1.401(a)(9)-8, A-6(b)(1).
2. Treas. Reg. §1.401(a)(9)-8, A-6(b)(2).
3. Treas. Reg. §1.401(a)(9)-8, A-6(c).
4. Treas. Reg. §1.401(a)(9)-8, A-7.

under a qualified plan primarily for distribution to employee participants as retirement benefits, and that payments to their beneficiaries are merely "incidental."[1]

The MDIB requirement applies only during an employee's life.[2] The MDIB requirement will be met if:

(1) non-annuity distributions are made in accordance with the individual account rules of IRC Section 401(a)(9) (Q 3804);[3]

(2) the employee's benefit is payable in the form of a life annuity for the life of the employee that satisfies the requirements of IRC Section 401(a)(9) (Q 3805);[4] or

(3) the employee's sole beneficiary as of the annuity starting date is the employee's spouse, and the distributions otherwise satisfy IRC Section 401(a)(9).

Payments under the annuity must be non-increasing, except for the exceptions explained at Q 3805.[5]

If distributions begin under a particular distribution option that is in the form of a joint and survivor annuity for the joint lives of the employee and a non-spouse beneficiary, the MDIB requirement will not be satisfied as of the date distributions begin unless the distribution option provides that annuity payments to be made to the employee on and after the employee's required beginning date will satisfy the conditions set forth in regulations.[6] Under those provisions, the periodic annuity payment payable to the survivor must not at any time on and after the employee's required beginning date exceed the applicable percentage of the annuity payment payable to the employee using the RMD MDIB Joint and Survivor Annuity Table found in Appendix F.[7]

The applicable percentage is based on how much older the participant is than the beneficiary as of their attained ages on their birthdays in the first calendar year for which distributions to the participant are required. For example, if the beneficiary is ten or fewer years younger, the survivor annuity may be 100 percent. If the age difference is greater than ten years, the maximum survivor annuity permitted is less than 100 percent. If there is more than one beneficiary, the age of the youngest beneficiary is used.[8]

If a distribution form includes a life annuity and a period certain, the amount of the annuity payments payable to the beneficiary need not be reduced during the period certain, but in the case of a joint and survivor annuity with a period certain, the amount of the annuity payments

1. Cf. Rev. Rul. 56-656, 1956-2 CB 280; Rev. Rul. 60-59, 1960-1 CB 154.
2. IRC Sec. 401(a)(9)(G); Treas. Reg. §1.401(a)(9)-2, A-1(b).
3. Treas. Reg. §1.401(a)(9)-5, A-1(d).
4. Treas. Reg. §1.401(a)(9)-6, A-2(a).
5. Treas. Reg. §1.401(a)(9)-6, A-2(b).
6. Treas. Reg. §1.401(a)(9)-6, A-2(c).
7. Treas. Reg. §1.401(a)(9)-6, A-2(c)(2).
8. Treas. Reg. §1.401(a)(9)-6, A-2(c).

payable to the beneficiary must satisfy the foregoing requirements after the expiration of the period certain.[1]

Period Certain Limitations

The period certain for annuity distributions commencing during the life of the employee with an annuity starting date on or after his required beginning date generally may not exceed the applicable distribution period for the employee for the calendar year that contains the annuity starting date.

If the employee's spouse is the employee's sole beneficiary and if the annuity provides only a period certain and no life annuity, the period certain may last as long as the joint and survivor life expectancy of the employee and spouse, if that period is longer than the applicable distribution period for the employee.[2]

If distributions commence after the death of the employee under the life expectancy rule explained in Q 3806, the period certain for any distributions commencing after death cannot exceed the distribution period determined under the life expectancy provisions of Treasury Regulation Section 1.401(a)(9)-5, A-5(b).

3814. How is an individual taxed when a qualified plan distribution fails to meet the minimum distribution requirements?

An individual who is required to take a minimum distribution is subject to an excise tax equal to 50 percent of the amount that should have been distributed as a minimum distribution but was not.[3]

The amount that must be distributed from a plan for a calendar year is the greater of (1) the amount that must be distributed for that year under the required minimum distribution ("RMD") rules (Q 3802 to Q 3812), or (2) the amount required to be distributed for that year under the minimum distribution incidental benefit ("MDIB") rule (Q 3813).

The excise tax is imposed on the recipient of the distribution for the taxable year beginning with or within the calendar year for which the distribution is required.[4] For purposes of the excise tax, a distribution for a participant's first distribution year is not required until April 1 of the following year (i.e., the required beginning date) (Q 3803).[5]

The excise tax may be waived if the IRS is satisfied that the shortfall was due to reasonable error and reasonable steps are being taken to remedy it.[6]

1. Treas. Reg. §1.401(a)(9)-6, A-2(d).
2. Treas. Reg. §1.401(a)(9)-6, A-3(a).
3. IRC Sec. 4974(a).
4. IRC Sec. 4974; Treas. Reg. §54.4974-2, A-6.
5. Treas. Reg. §54.4974-2, A-6.
6. IRC Sec. 4974(d); Treas. Reg. §54.4974-2, A-7.

In addition, if an employee dies before his or her required beginning date, the excise tax will be automatically waived if the recipient is the sole beneficiary, the RMD amount for a calendar year is determined under the life expectancy rule (Q 3806), and the entire distribution is completed by the end of the fifth calendar year following the calendar year of the employee's date of death.[1]

Individual Accounts

If distributions are being made in a form other than an annuity under a contract purchased from a life insurance company or directly from a defined benefit plan, the rules for individual accounts apply and the shortfall is determined by subtracting the actual amount of the distribution from the amount required under the RMD rules or the MDIB rule, whichever is greater.

For this purpose, if there is more than one permissible method for determining a required distribution, the default method provided by the regulations is used unless the plan provides otherwise (Q 3804 to Q 3812).

If distributions following the death of a participant are to be made under a method that complies with the five year rule (Q 3806), no amounts need be distributed, and thus there can be no excise tax, until the fifth calendar year following the participant's death. In that year, the recipient must take a distribution of the entire remaining balance.[2] The five year period is expanded to six years if one of the five years is 2009.[3]

Annuity Distributions

For purposes of the following rules, determinations as to whether there is a designated beneficiary and the designated beneficiary's life expectancy that is controlling are made under the rules explained in Q 3809.[4]

If distributions are being made under an annuity contract purchased from a life insurance company or under an annuity option of a defined benefit plan, and that annuity contract or option would meet the requirements of both the RMD rules and the MDIB rule, the shortfall is determined by subtracting the actual amount of distributions for the calendar year from the amount that should have been made for that calendar year under the provisions of the contract or option.[5]

If the annuity contract or option is an impermissible contract or option (i.e., one that fails to meet either the RMD rules or the MDIB rule), the shortfall is determined by subtracting the actual amount distributed for the calendar year from the minimum distribution determined under the following rules:

(1) In the case of a defined benefit plan, if distributions commence before the death of the participant, the minimum distribution is the amount that would have been

1. Treas. Reg. §54.4974-2, A-7.
2. Treas. Reg. §54.4974-2, A-3(c).
3. Notice 2009-82; 2009-2 C.B. 491.
4. Treas. Reg. §54.4974-2, A-4(b)(1)(ii).
5. Treas. Reg. §54.4974-2, A-4(a).

distributed under the plan's joint and survivor annuity option for the lives of the participant and designated beneficiary, which is permissible under both the RMD rules and the MDIB rule, and provides the greatest level amount payable to the participant on an annual basis. If the plan does not provide such an option, or there is no designated beneficiary, the minimum distribution is the amount that would have been distributed under the plan's life annuity option payable in a level amount for the life of the participant with no survivor benefit.[1]

(2) In the case of a defined benefit plan, if distributions commence after the death of the participant and a designated beneficiary is named under the impermissible annuity option, the minimum distribution is the amount that would have been distributed under the plan's life annuity option payable in a level amount for the life of the beneficiary. If there is no designated beneficiary, no amount need be distributed until the fifth calendar year following the participant's death, at which time the entire interest must be distributed.[2]

(3) In the case of a defined contribution plan, if distributions commence before the death of the participant, the minimum distribution is the amount that would have been distributed from an annuity contract purchased under the plan's joint and survivor annuity option for the lives of the participant and designated beneficiary, which is both permissible under the RMD rules and the MDIB rule, and provides the greatest level amount payable to the participant on an annual basis. If there is no designated beneficiary, the minimum distribution is the amount that would have been distributed from a contract purchased under the plan's life annuity option providing level payments for the life of the participant with no survivor benefit.[3]

If a plan does not provide a permissible annuity distribution option, the minimum distribution is the amount that would have been distributed under a theoretical annuity contract purchased with the amount used to purchase the impermissible annuity. If there is a designated beneficiary, this theoretical contract is a joint and survivor annuity, which (1) provides level annual payments, (2) would be permissible under the RMD rules, and (3) provides the maximum survivor benefit permissible under the MDIB rule. If there is no designated beneficiary, the theoretical contract is a life annuity for the life of the participant, which provides level annual payments and which is permissible under the RMD rules and the MDIB rule.[4]

(4) In the case of a defined contribution plan, if distributions commence after the death of the participant and a designated beneficiary is named under the impermissible annuity option, the minimum distribution is the amount that would have been distributed under a theoretical life annuity for the life of the designated beneficiary,

1. Treas. Reg. §54.4974-2, A-4(b)(1)(i).
2. Treas. Regs. §§54.4974-2, A-4(b)(1)(ii), 54.4974-2, A-4(b)(3).
3. Treas. Reg. §54.4974-2, A-4(b)(2).
4. Treas. Reg. §54.4974-2, A-4(b)(2).

which provides level annual payments and which would be permissible under the RMD rules. If there is no designated beneficiary, no amount need be distributed until the fifth calendar year following the participant's death, at which time the entire interest must be distributed.[1]

The amount of the payments will be determined using the interest rate and mortality tables prescribed under IRC Section 7520 using the distribution commencement date determined under Treasury Regulation Section 1.401(a)(9)-3, A-3 and using the age of the beneficiary as of his or her birthday in the calendar year that contains that date.[2]

State Insurer Delinquency Proceedings

There is no violation of the minimum distribution requirements and thus no excise tax if a shortfall occurs because assets are invested in a contract issued by an insurance company that is in the midst of state insurer delinquency proceedings. The RMD rules are not violated merely because payments were reduced or suspended by reason of state insurer delinquency proceedings against the life insurance company issuing the annuity. This amount and any additional amount accrued during this period will be treated as though it is not vested during such proceedings. Any distributions with respect to such amounts must be made under the relevant rules for non-vested benefits described in Treasury Regulations Sections 1.401(a)(9)-5, A-8 or 1.401(a)(9)-6, A-6 (Q 3804, Q 3805).

Alienation of Benefits

3815. What restrictions apply to the assignment or alienation of a participant's qualified plan benefit?

A qualified plan must provide that benefits under the plan generally may not be assigned, alienated, or subject to garnishment or execution.[3] Limited exceptions are provided, including a qualified domestic relations order ("QDRO," see Q 3816), for collection of taxes or certain federal judgments, or when a participant has committed a breach of fiduciary duty, or a criminal act, against the plan.[4]

The U.S. Supreme Court has held that, for purposes of the anti-alienation provision, a working business owner and the owner's spouse are ERISA-protected participants, provided the plan covers one or more employees other than the owner and spouse.[5]

Bankruptcy Protection

The Supreme Court has held that qualified plan interests generally are protected from the reach of plan participants' creditors in bankruptcy.[6] The U.S. Supreme Court also has extended

1. Treas. Regs. §§54.4974-2, A-4(b)(2), 54.4974-2, A-4(b)(3).
2. Treas. Reg. §54.4974-2, A-4(b)(2)(ii).
3. IRC Sec. 401(a)(13), ERISA Sec. 206(d).
4. IRC Sec. 401(a)(13)(C).
5. *Yates v. Hendon*, 124 S. Ct. 1330 (2004).
6. *Patterson v. Shumate*, 112 S.Ct. 2242 (1992).

the protection offered to qualified plan assets under the federal Bankruptcy Code to an IRA containing a rolled over lump sum distribution from a qualified plan.[1] Even where it is unclear whether a plan was tax qualified, courts have allowed anti-alienation provisions to stand.[2]

Payment of a participant's accrued benefit to a bankruptcy trustee pursuant to a bankruptcy court order, even with the participant's consent, is a prohibited alienation for qualification purposes.[3] A plan administrator, if the plan permits, may draw a loan check or a hardship withdrawal check payable to the participant and send such checks directly to the bankruptcy trustee, to be endorsed over to the trustee by the participant, without violating the anti-alienation prohibition.[4] Of course, the participant will need to be in agreement with this arrangement.

A Bankruptcy Code requirement that debtors apply all "projected disposable income to be received … to make payments under the [bankruptcy] plan" does not require a plan participant to take out a plan loan to pay toward his or her debt, because plan loans are not "income" for bankruptcy purposes.[5] If a participant has already taken a plan loan and subsequently files bankruptcy, amounts used to repay the loan do not receive preferential treatment merely because the loans are secured by plan assets. In at least two rulings, the payments were not deemed necessary for the participant's "maintenance and support."[6]

QDRO Exception

A plan may not distribute, segregate, or otherwise recognize the attachment of any portion of a participant's benefits in favor of the participant's spouse, former spouse, or dependents unless such action is mandated by a QDRO (Q 3816).[7] The voluntary partition of a participant's vested account balance between the participant's spouse and the participant in a community property state is an alienation of benefits.[8] The Tax Court ruled that a participant's voluntary waiver of benefits was a prohibited alienation, despite the PBGC's approval of the plan's termination; the waiver resulted in the plan's disqualification and the participant, who was the sole shareholder, was taxed on benefits the participant did not receive.[9]

Federal Taxes and Judgments

An anti-alienation provision will not prevent collection of federal taxes from the plan benefits.[10] The IRS determined that a retirement plan was not obligated to honor an IRS levy on the benefits of a participant who was not yet entitled to receive a distribution; instead, the levy could be ignored until such time as the participant was eligible for a distribution.[11]

1. See *Rousey v. Jacoway*, 125 S. Ct. 1561 (2005).
2. *Traina v. Sewell*, 180 F.3d 707 (5th Cir. 1999) (citing *Baker v. LaSalle*, 114 F.3d 636 (7th Cir. 1997)). See also *United States v. Wofford*, 560 F.3d 341 (5th Cir. 2009).
3. Let. Ruls. 9011037, 8910035, 8829009.
4. Let. Rul. 9109051.
5. *In re Stones*, 157 Bankr. 669 (Bankr. S.D.Cal. 1993).
6. *In re Cohen*, 246 BR 658 (Bankr. D. Colo. 2000); *In re Estes*, 254 BR 261 (Bankr. D. Idaho 2000).
7. IRC Secs. 401(a)(13)(B), 414(p).
8. Let. Rul. 8735032.
9. *Gallade v. Comm.*, 106 TC 355 (1996).
10. Treas. Reg. §1.401(a)-13(b)(1); *Iannone v. Comm.*, 122 TC 287 (2004).
11. FSA 199930039.

The ability of the IRS to attach pension benefits ended with the participant's death, because benefits payable to a participant's son as beneficiary did not constitute "property" to which a tax lien could attach.[1]

In some cases, the IRS has permitted the collection of criminal fines and restitution against plan assets.[2] The IRS has privately ruled that benefits of individuals already in "pay status" may be subject to garnishment under the Federal Debt Collection Procedures Act regardless of whether the defendant is a plan participant or a beneficiary. The IRS noted that such collections could be made whether the recipient was a government entity or a private party; the government, in effect, "steps into the shoes of the taxpayer," receiving funds the taxpayer would have received and applying them toward a valid debt of the taxpayer. These collections did not extend to individuals not yet in pay status, because they were not yet eligible for a distribution under the terms of the plan.[3]

Crime or Fiduciary Violation

A plan generally may offset a participant's benefit under a qualified plan to recover certain amounts that the participant is ordered or required to pay.[4] For this exception to apply, the order or requirement to pay must arise under a judgment of conviction for a crime involving the plan, under a civil judgment entered by a court in an action brought in connection with a violation of the fiduciary responsibility provisions of ERISA, or pursuant to a settlement agreement between the Department of Labor or the Pension Benefit Guaranty Corporation and the participant in connection with a fiduciary violation. The judgment, order, decree, or settlement specifically must provide for the offset of all or part of the amount required to be paid to the plan.

If a plan is subject to survivor annuity rules (Q 3791), the offset will be permitted if the spouse has consented to the offset or signed a waiver of the survivor annuity rules, the spouse is ordered or required to pay an amount to the plan in connection with a fiduciary violation (e.g., the spouse is held responsible for the fiduciary violation), or the judgment, order, decree, or settlement provides that the spouse retains the right to the minimum survivor annuity.[5] Special rules are provided for determining the amount of the minimum survivor annuity.[6]

Other Exceptions

A plan may provide that, after a benefit is in pay status, the participant or beneficiary receiving such benefit may make a voluntary and revocable assignment not to exceed 10 percent of any benefit payment, provided the assignment is not for the purpose of defraying plan administrative costs.[7]

1. *Asbestos Workers Local No. 23 Pension Fund v. U.S.*, 303 F. Supp. 2d 551 (D.C. Pa. 2004).
2. See Let. Rul. 200342007.
3. Let. Rul. 200426027.
4. IRC Sec. 401(a)(13).
5. IRC Sec. 401(a)(13)(C)(iii).
6. See IRC Sec. 401(a)(13)(D).
7. IRC Sec. 401(a)(13)(A); Treas. Reg. §1.401(a)-13(d)(1).

Payment, pursuant to a court order that is the result of a judicial determination that benefits cannot be paid to a beneficiary who murdered the plan participant, is permitted if the order conforms to the terms of the plan for directing payments when there is an ineligible beneficiary.[1]

Planning Point: Courts sometimes hold that ERISA preempts state slayer statutes. The U.S. Supreme Court has not yet decided the issue. If faced with this issue, the plan can argue that federal common law precludes payment to a beneficiary who murders the participant.[2]

A disclaimer of qualified plan benefits that satisfies the requirements of state law and IRC Section 2518(b) is not a prohibited assignment or alienation.[3]

An anti-alienation provision also will not prevent a plan from holding a rolled over distribution from another plan subject to an agreement to repay a part of the distribution in the event of early termination of the other plan.[4]

A loan from a plan made to a participant or beneficiary and secured by a participant's accrued non-forfeitable benefit is not treated as an assignment or alienation if the loan is exempt from the excise tax on prohibited transactions or would be exempt if the participant or beneficiary were a disqualified person.[5]

A participant or beneficiary may direct payment of his or her plan benefit payment to a third party, including the employer, if the arrangement is revocable and the third party files with the plan administrator a written acknowledgement stating that he or she has no enforceable right to any plan benefit other than payments actually received. The written acknowledgement must be filed within ninety days after the arrangement is entered into.[6] After the death of a participant, an assignment made pursuant to a bona fide settlement between good faith adverse claimants to the participant's pension plan benefits was not invalidated by ERISA's anti-alienation provision.[7]

3816. What is a qualified domestic relations order?

A qualified domestic relations order ("QDRO") is a judgment, decree, or order (including an approval of a property settlement agreement) that awards all or a portion of a participant's benefits to an alternate payee and that meets all the requirements under the IRS for being qualified.

A plan may distribute, segregate, or otherwise recognize the attachment of any portion of a participant's benefits in favor of the participant's spouse, former spouse, or dependents without violating the restrictions on alienation of benefits (Q 3815) only if such action is mandated by

1. Let. Rul. 8905058.
2. See *Standard Ins. Co. v. Coons*, 1998 U.S. App. LEXIS 5333 (9th Cir. 1998); see also dicta in *Egelhoff v. Egelhoff*, 532 U.S. 141 (2000).
3. GCM 39858 (9-9-91).
4. *Francis Jungers, Sole Proprietorship v. Comm.*, 78 TC 326 (1982), *acq*. 1983-1 CB 1.
5. Treas. Reg. §1.401(a)-13(d)(2); Rev. Rul. 89-14, 1989-1 CB 111.
6. Treas. Regs. §§1.401(a)-13(d), 1.401(a)-13(e); TD 7534.
7. *Stobnicki v. Textron, Inc.*, 868 F.2d 1460 (5th Cir. 1989).

a QDRO.[1] Only a spouse, former spouse, child, or other dependent of a participant may be classified as an alternate payee under a QDRO.

The following requirements must be met for a domestic relations order ("DRO") to be qualified:

(1) it must relate to the provision of child support, alimony, or property rights to a spouse, former spouse, child, or other dependent;

(2) it must be made under a state's community property or other domestic relations law;

(3) it must create, recognize, or assign to the spouse, former spouse, child, or other dependent of the participant the right to receive all or a portion of a participant's plan benefits;

(4) it must clearly specify the names and, unless the plan administrator has reason to know them, the addresses of the participant and each alternate payee, the amount or percentage of the participant's benefit to be paid to each alternate payee (or a method for determining the amount), the number of payments or the period to which the order applies, and each plan to which the order applies; and

(5) it may not require the plan to provide any type or form of benefit or benefit option not otherwise provided under the plan, to pay increased benefits, or to provide increased benefits to an alternate payee that are required to be paid to another alternate payee under another previously ordered qualified DRO.[2]

A distribution from a governmental plan, a church plan, or an eligible Section 457 governmental plan (Q 3568) will be treated as made pursuant to a QDRO as long as the domestic relations order meets requirements (1) through (3).[3]

Model language for a QDRO is set forth in Bulletin 97-11.[4]

A marital settlement agreement that was incorporated into a divorcing couple's dissolution agreement constituted a QDRO, not merely a property settlement.[5]

An amendment to a divorce decree did not constitute a QDRO, and thus could not confer on the ex-wife a 50 percent interest in the participant's preretirement survivor annuity because prior to the amendment the participant had died and the benefits had lapsed. As a result, the amendment impermissibly provided for increased benefits.[6]

1. IRC Secs. 401(a)(13)(B), 414(p).
2. IRC Sec. 414(p)(1).
3. IRC Sec. 414(p)(11).
4. 1997-1 CB 379.
5. *Hawkins v. Comm*. 86 F.3d 982 (10th Cir. 1996), *rev'g* 102 TC 61.
6. *Samaroo v. Samaroo*, 193 F.3d 185 (3d Cir. 1999).

In a private ruling, the IRS approved the use of a second QDRO to secure other marital obligations. The second QDRO ordered the segregation of a portion of the husband's retirement plan benefit for the wife's benefit.[1]

Most federal circuit courts hold that a QDRO is enforceable after a participant's death.[2] The Department of Labor has issued regulations under which a QDRO will not fail to be treated as valid merely because it revises, or is issued after, another QDRO. The regulations also provide that a QDRO will not be treated as invalid solely because of the time it was issued.[3]

The applicability of the QDRO provisions to benefits other than those provided by qualified plans is not fully clear. After having ruled in 1992 that they were inapplicable to nonqualified deferred compensation plans and welfare benefit plans, a Michigan district court reversed itself in 1996, holding that a QDRO provision should be followed with respect to the disposition of a welfare plan, such as life insurance.[4]

The Court of Appeals for the Seventh Circuit has ruled that the QDRO provisions of ERISA were applicable to group term life insurance and other welfare plans.[5]

Final regulations governing Section 403(b) plans extend the application of the QDRO rules to tax-sheltered annuity contracts, at least with respect to taxable years beginning after 2005.[6]

A QDRO generally may not require that the plan provide any form of benefit not otherwise provided under the plan and may not require that the plan provide increased benefits. Within certain limits, it is permissible for a QDRO to require that payments to an alternate payee begin on or after the participant's earliest retirement age, even though the participant has not separated from service at that time. For these purposes, a participant's earliest retirement age is the earlier of (1) the date that the participant is entitled to a distribution under the plan or (2) the later of (i) the date the participant reaches age fifty or (ii) the earliest date on which the participant could begin receiving benefits under the plan if the participant separated from service.[7] A plan may provide for payment to an alternate payee prior to the earliest retirement age as defined in the IRC.[8]

Planning Point: Employers should consider drafting their retirement plans to offer in-service distributions to alternate payees so as not to be burdened with administering the benefits of employees' ex-spouses, a group that by its nature may be hostile to the employer. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

1. See Let. Rul. 200252097.
2. See *Hogan v. Raytheon*, 302 F3d 854 (8th Cir. 2002); *Trustees of the Directors Guild of America-Producer Pension Benefits Plans v. Tise*, 234 F.3d 415 (9th Cir. 2000); see also IRC Sec. 414(p)(7), ERISA Sec. 206(d)(3)(H).
3. 29 CF.R. §2530.206(b) and (c).
4. See *Metropolitan Life Ins. Co. v. Fowler*, 922 F. Supp. 8 (E.D. Mich. 1996), rev'g *Metropolitan Life Ins. Co. v. Person*, 805 F. Supp. 1411 (E.D. Mich. 1992).
5. See *Metropolitan Life Ins. Co. v. Wheaton*, 42 F.3d 1080 (7th Cir. 1994).
6. See Treas. Regs. §§1.403(b)-10(c); 1.403(b)-11(a).
7. IRC Sec. 414(p)(4)(B).
8. Treas. Reg. §1.401(a)-13(g)(3).

A domestic relations order requiring payment of benefits to an alternate payee is not qualified if the benefits are required to be paid to another alternate payee under a previous QDRO. The IRS has determined that the assignment of or placement of a lien on a participant's retirement account to secure payment of obligations under the terms of a QDRO was not a prohibited alienation.[1]

The IRC provides that, to the extent specified in a QDRO, the former spouse of a participant (and not the current spouse) may be treated as a surviving spouse for purposes of the survivor benefit requirements and, for that purpose, a former spouse will be treated as married to the participant for the requisite one year period if the former spouse and the participant had been married for at least one year (Q 3792).[2] In the absence of this provision, a former spouse was not entitled to receive any benefits where the husband died before becoming entitled to receive retirement benefits and the preretirement survivor annuity was payable to the current spouse.[3]

The plan administrator is required to make the determination as to whether an order is a QDRO. All plans must establish reasonable procedures for making such determinations.[4] In addition, a plan administrator who has reason to believe an order is a sham or is questionable in nature must take reasonable steps to determine its credibility.[5]

A plan administrator is not required under the IRC or ERISA to review the correctness of the determination that an individual is a surviving spouse under state domestic relations law.[6] A plan administrator is not required to, and should not, "look beneath the face" of a state court order to determine whether amounts to which it relates were properly awarded.[7]

Final DOL regulations effective August 9, 2010 make it clear that a plan administrator cannot disqualify a QDRO solely because it is issued after or revises another domestic relations order or QDRO, or because it is issued after the participant's death, divorce, or annuity starting date.[8]

The DOL has stated that nothing in ERISA Section 206(d)(3) precludes a state court from altering or modifying an earlier QDRO of a couple petitioning the court for such a change, provided the new order satisfies the requirements of a QDRO. In such a case, the DOL noted that the new order would operate on a prospective basis only.[9]

A plan may provide for a "hold" to be placed on a participant's account while the determination is being made as to whether an order is a QDRO; however, where a plan with such a provision

1. Let. Ruls. 9234014, 200252093.
2. IRC Sec. 414(p)(5); Treas. Reg. §1.401(a)-13(g)(4).
3. *Dugan v. Clinton*, 1987 U.S. Dist. LEXIS 4276 (N.D. Ill. 1987).
4. IRC Secs. 414(p)(6), 414(p)(7).
5. DOL Adv. Op. 99-13A.
6. DOL Adv. Op. 92-17A.
7. *Joint Trs. of the Int'l Longshore & Warehouse Union-Pacific Mar. Ass'n Pension Plan v. Pritchow*, 2012 U.S. Dist. LEXIS 179633 (W.D. Wash. Dec. 19, 2012); *Brown v. Cont'l Airlines, Inc.*, 647 F.3d 221 (5th Cir. 2011); *Blue v. UAL Corp.*, 160 F.3d 383 (7th Cir. 1998).
8. 29 CFR 2530.206.
9. DOL Adv. Op. 2004-02A.

went beyond its written procedures and placed a hold on an account before the order was received but after the divorce was final, the hold violated ERISA.[1] The Department of Labor also has stated that plans are not permitted to impose separate fees for the costs of these procedures to individual participants or alternate payees.[2]

For the taxation of payments made pursuant to a QDRO, see Q 3841 and Q 3860. For an explanation of the effect of a QDRO on the minimum distribution requirements, see Q 3812.

Top-Heavy Plan Requirements

3817. What do the top-heavy rules require with respect to a qualified plan?

In any plan year in which a plan is a top-heavy plan (Q 3818), additional qualification requirements must be met.[3]

Moreover, except to the extent provided in the regulations, all non-exempt plans, whether or not actually top-heavy, must contain provisions that meet the additional top-heavy qualification requirements and that will become effective should a plan become top-heavy.[4]

Plans established and maintained by the United States, by state governments and political subdivisions thereof, and by agencies and instrumentalities of any of these, are exempt from the top-heavy requirements.[5] Also, the top-heavy rules are not applicable to SIMPLE IRA plans (Q 3654), SIMPLE 401(k) plans (Q 3715), safe harbor 401(k) plans (Q 3710), or automatic enrollment safe harbor 401(k) plans (Q 3707).[6] PPA '06 Section 902(c) amended IRC Section 416(g)(4)(H) to exempt from the top-heavy rules plans consisting solely of (1) cash or deferred arrangements that meet the requirements of Section 401(k)(12) or 401(k)(13) and (2) matching contributions which meet the requirements of Section 401(m)(11) or 401(m)(12).

As to when a participant is a key employee for purposes of the top-heavy rules, see Q 3828. For the additional qualification requirements applicable to top-heavy plans, see Q 3823.

3818. When is a single plan top-heavy?

Where an employer maintains only one qualified plan, that plan is a top-heavy plan with respect to a plan year if the present value of the cumulative accrued benefits under the plan, or the aggregate account balances if the plan is a defined contribution plan, for key employees (Q 3828) exceeds 60 percent of the present value of the cumulative accrued benefits under the plan, or the aggregate account balances, for all employees.[7]

For purposes of determining the present values of accrued benefits, or the sums of account balances, benefits derived from both employer contributions and nondeductible employee

1. *Schoonmaker v. The Employee Sav. Plan of Amoco Corp.*, 987 F.2d 410 (7th Cir. 1993).
2. DOL Adv. Op. 94-32A.
3. IRC Sec. 401(a)(10)(B).
4. For rules and exemptions, see Treas. Regs. §§1.416-1, T-35 to 1.416-1, T-38.
5. IRC Sec. 401(a)(10)(B).
6. IRC Secs. 416(g)(4)(G), 401(k)(11)(D)(ii); IRC Sec. 416(g)(4)(H).
7. IRC Sec. 416(g)(1)(A).

contributions are taken into account; benefits derived from deductible employee contributions are disregarded. Deductible employee contributions are certain contributions made before 1987; the term does not refer to salary reductions or employee deferrals.

Any reasonable interest rate assumption may be used to calculate these present values, but the IRS automatically will accept as reasonable a rate that is not less than 5 percent or greater than 6 percent. The interest rate used need not be the same as other assumptions used in the plan (e.g., the rate assumed for funding purposes). Where an aggregation group consists of two or more defined benefit plans, the interest rate assumptions used to calculate the present values must be the same in all plans.[1]

Present values and account balances generally are determined on the last day of the prior plan year, but when testing for top-heaviness with respect to the first plan year (as well as the second) of a new plan, the determination date is the last day of the first plan year.[2]

In the case of a defined contribution plan, the balance in each account on the determination date is calculated by adjusting the balance of each account as of the most recent valuation date occurring within twelve months prior to the determination date for contributions due as of the determination date.[3]

For defined benefit plans, the present value of an accrued benefit as of the determination date generally is determined as of the most recent valuation date occurring in the previous twelve months. Special rules apply in the case of a new defined benefit plan in its first and second plan years.[4]

The cumulative accrued benefit of non-key employees must be determined under the method used for accrual purposes for all plans of the employer or, if there is no such method, as if such benefit accrued not more rapidly than under the fractional method (Q 3667).[5]

In determining these present values and account balances, any distribution (generally including death benefits) made from the plan with respect to any employee during the one-year period ending on the determination date, and that is not already reflected in the present value or account balance, must be added back to the present value of that employee's accrued benefit or to his or her account balance, whichever is applicable.[6] In the case of a distribution made for a reason other than severance from employment, death, or disability, a five-year look-back period applies for this purpose.[7]

If an individual has not performed any services for his or her employer during the one-year period ending on the determination date, the individual's accrued benefit and account are not to

1. Treas. Regs. §§1.416-1, T-26, 1.416-1, T-28.
2. IRC Sec. 416(g)(4)(C).
3. Treas. Reg. §1.416-1, T-24.
4. Treas. Reg. §1.416-1, T-25.
5. IRC Sec. 416(g)(4)(F).
6. IRC Sec. 416(g)(3)(A); Treas. Reg. §1.416-1, T-30, T-31.
7. IRC Sec. 416(g)(3)(B).

be taken into account for purposes of determining whether the plan is top-heavy.[1] If an individual was a key employee in a previous plan year but currently is a non-key employee for purposes of the top-heavy test, the individual's cumulative accrued benefit (or account balance) is totally disregarded.

The terms "key employee" (Q 3828) and "employee" should be read to include their beneficiaries, so that the beneficiary of a key employee is treated as a key employee and the beneficiary of a former key employee is treated as a former key employee.[2] This apparently means that for purposes of testing top-heaviness, an individual's accrued benefit or account balance must be considered in its entirety and not allocated between the individual and his or her beneficiaries. For plan years beginning before January 1, 2002, it also meant that the accrued benefit or account balance of a deceased key employee, even though payable (or paid) to his or her beneficiary, was treated as that of a key employee for four years.[3]

A plan will not be treated as violating the top-heavy rules merely on account of the making of, or the right to make, catch-up contributions (Q 3706) by participants age fifty or over, under the provisions of IRC Section 414(v), so long as a universal availability requirement is met.[4]

3819. When are multiple plans top-heavy?

Where an employer maintains more than one qualified plan, some or all of those plans will be aggregated and tested as a group for top-heaviness.

Specifically, all qualified plans (including collectively-bargained plans) of an employer that cover at least one key employee (i.e., key employee plans) and any qualified plans that enable an otherwise discriminatory key employee plan to satisfy the nondiscrimination requirements of IRC Sections 401(a)(4) or 410 (Q 3761 to Q 3779, Q 3710 to Q 3731) are required to be aggregated into a single group.

In addition, an employer may designate any other qualified plan or plans (including collectively-bargained plans) not required to be aggregated under the above rules to be included in an existing aggregation group, provided that the resulting group, taken as a whole, would continue to satisfy IRC Sections 401(a)(4) and 410.

If an aggregation group is top-heavy, all plans required to be included in the group under the above rules will be considered top-heavy plans; any plan included in the group solely because of the employer's designation will not be treated as top-heavy. Even though a collectively-bargained plan covering a key employee might be part of a top-heavy aggregation group because it was required to be aggregated, that collectively-bargained plan will be excepted from the faster vesting, minimum benefits, and maximum compensation requirements discussed in Q 3823.[5]

1. IRC Sec. 416(g)(4)(E).
2. IRC Sec. 416(i)(5); Treas. Reg. §1.416-1, T-12.
3. See IRC Sec. 416(i)(1)(A), prior to amendment by EGTRRA 2001.
4. IRC Sec. 414(v)(3)(B).
5. See Treas. Reg. §1.416-1, T-3.

If an aggregation group is not top-heavy, no plan in the group will be considered top-heavy, even though one or more plans composing the group would be top-heavy if tested alone.[1]

The procedure for testing top-heaviness of an aggregation group is the same as that discussed above for a single plan, except that the values tested are the sums of the respective present values and account balances determined for each plan, as of its determination date, composing the group. When plans composing the aggregation group have different plan years, the test is carried out using the determination dates that fall within the same calendar year.[2]

If only one of the employer's plans is a key employee plan and that plan, by itself, satisfies the nondiscrimination requirements of IRC Sections 401(a)(4) and 410, that plan will be tested as a single plan unless the employer elects to designate another plan for aggregation with the key employee plan.

3820. How do the top-heavy rules apply to simplified employee pension plans?

For purposes of testing for top-heaviness, a simplified employee pension plan, including a SAR-SEP (Q 3653), is treated as a defined contribution plan. An employer may elect to use aggregate employer contributions to the simplified employee pension plan, rather than aggregate account balances, for purposes of the top-heavy test.[3]

3821. Are rollover plans subject to the top-heavy rules?

How amounts rolled over (or otherwise transferred) to or from a qualified plan are treated for purposes of determining whether a plan is top-heavy depends on the surrounding circumstances.

If a rollover or transfer is initiated other than by the employee, as in the case of a merger or division of plans, or is made between plans of the same employer, or related employers required to be aggregated under IRC Section 414, the amount rolled over is counted as part of an employee's accrued benefits by the receiving plan but is disregarded by the distributing plan.

If a rollover or transfer is initiated by an employee, regardless of who initiated the distribution, and is made between plans of unrelated employers, the rollover distribution generally must be added back to the distributing plan for a one year period and generally is disregarded by the receiving plan.[4]

Notice 2013-74[5] provides that an in-plan Roth rollover is considered a "related rollover" and so the accepting plan must include the rollover in determining the present value of accrued benefits for top-heavy status.

1. Treas. Reg. §1.416-1, T-9.
2. Treas. Reg. §1.416-1, T-23.
3. IRC Sec. 416(i)(6).
4. IRC Sec. 416(g)(4)(A); Treas. Reg. §1.416-1, T-32.
5. 2013-52 I.R.B. 819.

3822. Are there simplified calculation methods for a top-heavy plan?

Precise top-heavy ratios need not be computed every year so long as the plan administrator knows whether or not the plan is top-heavy. For this purpose, and for the purpose of demonstrating to the IRS that a plan is not top-heavy, an employer may use computations that are not precisely in accordance with the top-heavy rules but that mathematically prove that the plan is not top-heavy. Several such methods are provided in the regulations.[1]

3823. What special qualification requirements apply to top-heavy plans?

In addition to the qualification requirements that apply to qualified plans generally (Q 3758), special requirements are imposed by the IRC on top-heavy plans. In addition, top-heavy simplified employee pension plans are required to meet certain minimum contribution requirements. In applying these requirements the common control, controlled group, and affiliated service group aggregation rules apply (Q 3830, Q 3832). Under some circumstances, "leased" employees may be imputed to an employer (Q 3826).[2]

The following requirements must be met by top-heavy plans in general; top-heavy simplified employee pensions must meet only the minimum contribution requirements discussed below.

Fast Vesting

A top-heavy plan must provide that an employee has a non-forfeitable right to his or her accrued benefit derived from employer contributions in accordance with one of the two following requirements:

1. *Three-year vesting*. An employee who has completed at least three years of service with the employer must have a non-forfeitable right to 100 percent of his or her accrued benefit.[3]

2. *Six-year graded vesting*. An employee who has completed at least two years of service must have a non-forfeitable right to at least the following: 20 percent of his or her accrued benefit after two years of service, and 20 percent additional for each of the following years of service, reaching 100 percent after six years of service with the employer.[4]

Except to the extent that they are inconsistent with these fast vesting schedules, the rules that pertain to vesting in qualified plans generally (including years of service and breaks in service, etc.) apply for purposes of the fast vesting requirements.[5] Thus, the fast vesting schedules are not safe harbors; even faster vesting may be required by IRC Section 411(d) where there is a pattern of abuse (Q 3785).

1. Treas. Reg. §1.416-1, T-39.
2. Guidelines for applying the top-heavy rules may be found in Treas. Reg. §1.416-1.
3. IRC Sec. 416(b)(1)(A).
4. IRC Sec. 416(b)(1)(B).
5. IRC Sec. 416(b)(2); see Treas. Regs. §§1.416-1, V-1; 1.416-1, V-2.

When a plan becomes top-heavy, fast vesting under one of the two schedules generally must be applied to all benefits accrued under the plan for the current plan year and all prior plan years (including benefits accrued in years before the plan became top-heavy and benefits accrued before the effective date of the top-heavy rules). The accrued benefit of any employee who does not have an hour of service after the plan became top-heavy, and any accrued benefits that were forfeited before the plan became top-heavy, need not be covered by the fast vesting schedule.[1]

Although the IRC does not require that fast vesting be applied to benefits accrued in future plan years in which a plan is not top-heavy, a return to the plan's slower vesting when the plan ceases to be top-heavy in many cases may be impractical or impossible. For example, IRC Section 411(a)(10) requires that a change in vesting schedules not reduce a participant's non-forfeitable percentage in his or her accrued benefit and that certain participants be allowed to elect to be covered by the previous vesting schedule (Q 3785).[2]

Minimum Benefits and Contributions

For any top-heavy plan year, a plan generally must provide a minimum benefit or contribution for each non-key employee who is a participant.[3] Integration (i.e., permitted disparity) must be disregarded for purposes of determining a minimum benefit or contribution.

Defined benefit plans. A top-heavy defined benefit plan generally must provide an accrued benefit derived from employer contributions for each non-key employee participant that, when expressed as an annual retirement benefit, is not less than the participant's average compensation multiplied by the lesser of 2 percent for each year of service with the employer or 20 percent.[4]

Years of service are the same as the "years of service" taken into account for the ordinary vesting rules (Q 3785), but years of service in which non-top-heavy plan years end are not counted for this purpose; years in which no key employee or former key employee benefits under the plan also are not counted.[5]

Average compensation is a participant's average annual compensation for the period of consecutive years (not exceeding five) during which the participant had the greatest aggregate compensation from the employer.[6] Compensation for any year that is not a year of service is disregarded.[7]

Similarly, unless the plan provides otherwise, compensation (Q 3783) for any year beginning after a plan has ceased forever to be top-heavy, is not counted.[8] Annual retirement benefit

1. Treas. Reg. §1.416-1, V-3.
2. See Treas. Reg. §1.416-1, V-7. For additional rules regarding vesting in a top-heavy plan, see Treasury Regulations §§1.416-1, V-5 and 1.416-1, V-6.
3. IRC Sec. 416(c); Treas. Reg. §1.416-1, M-1.
4. For the non-key employees for which a minimum benefit is not required, see Treasury Regulation §1.416-1, M-4.
5. IRC Sec. 416(c)(1)(C)(iii).
6. IRC Sec. 416(c)(1)(D)(i).
7. IRC Sec. 416(c)(1)(D)(ii).
8. IRC Sec. 416(c)(1)(D)(iii).

means a benefit payable annually in the form of a single life annuity (with no ancillary benefits) beginning at the normal retirement age under the plan.[1]

For the application of the minimum benefit requirement to a defined benefit plan funded exclusively by level premium insurance contracts, see Treasury Regulation Section 1.416-1.[2]

Defined contribution plans. For each plan year in which a defined contribution plan or simplified employee pension plan is top-heavy, employer contributions and forfeitures allocated to the account of each non-key employee participant must not be less than the amount that is calculated by multiplying the participant's compensation by the lesser of 3 percent or the percentage that is the highest contribution rate made for a key employee.[3]

For purposes of determining the highest contribution rate received by a key employee, employer contributions and forfeitures made on behalf of each key employee under the plan or, if the plan is part of a required aggregation group (Q 3818), all defined contribution plans included in the group, are divided by his or her total compensation for the year (but not more than $260,000, as indexed for 2014, up from $255,000 in 2013).[4]

Although employer contributions attributable to salary reduction or similar arrangements may not be disregarded when calculating the minimum contribution requirement for a top-heavy defined contribution plan, these contributions may not be used to satisfy the top-heavy minimum contribution requirement.[5] Non-elective contributions and employer matching contributions may be used to satisfy the minimum contribution requirement, but such amounts generally cannot then be used in the ACP or ADP test (Q 3731, Q 3732).[6] For application of the minimum contribution requirement in the case of a plan that has received a waiver of the minimum funding requirements, see Treasury Regulation Section 1.416-1.[7]

If a top-heavy defined contribution plan required to be included in an aggregation group (Q 3818) with a discriminatory defined benefit plan enables that defined benefit plan to satisfy the nondiscrimination requirements of IRC Sections 401(a)(4) and 410, the minimum contribution is 3 percent of the participant's compensation, and the highest contribution rate for key employees is disregarded.[8]

Defined benefit and defined contribution plans. Although an employer that maintains both a top-heavy defined benefit plan and a top-heavy defined contribution plan is not required by the top-heavy rules to provide a non-key employee who participates in both plans with a minimum contribution and a minimum benefit, the non-key employee may not receive less under the combined plans than he or she would if he or she participated in only one of the plans.[9]

1. IRC Sec. 416(c)(1)(E); Treas. Regs. §§1.416-1, M-2, 1.416-1, M-3.
2. Treas. Reg. §1.416-1, M-17.
3. IRC Sec. 416(c)(2); Treas. Reg. §1.416-1, M-7 to M-9.
4. IRC Sec. 401(a)(17); Treas. Reg. §1.416-1, M-7; Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
5. Treas. Reg. §1.416-1, M-20.
6. Treas. Regs. §§1.416-1, M-18, 1.416-1, M-19.
7. Treas. Reg. §1.416-1, M-9.
8. IRC Sec. 416(c)(2)(B)(ii)(II).
9. See TEFRA Conf. Rep., 1982-2 CB 677; see IRC Sec. 416(f).

The regulations provide four safe harbor rules a plan may use to determine the minimum an employee must receive.[1]

Collective bargaining units. The minimum contribution and minimum benefit requirements do not apply in the case of any employee covered by a collective bargaining agreement if there is evidence that retirement benefits were the subject of good faith bargaining.[2]

Integration

Although the IRC does not prohibit integration in a top-heavy plan, the fast vesting and minimum benefit (and contribution) requirements above must be satisfied without taking into account employer payments of FICA taxes or contributions or benefits made or received under any other federal or state law.[3]

Miscellaneous Qualification Plans

3824. What other qualification requirements must be met in order for a plan to be qualified?

A. *Permanence*. A qualified plan must be a permanent, as distinguished from a temporary, program. Thus, although an employer may reserve the right to amend or terminate the plan, the abandonment of the plan for any reason other than business necessity within a few years after its establishment will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. This will especially be true if, for example, a pension plan is abandoned soon after pensions have been funded for the highly-paid or stockholder employees.[4]

B. *Benefits After Merger*. The plan must provide that in the case of any merger or consolidation with, or transfer of assets or liabilities to, any other plan, each participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated).[5] (This requirement does not apply to certain multiemployer plans). Shifting assets between funding media used for a single plan (e.g., between trusts and annuity contracts) is not a transfer of assets or liabilities.[6]

C. *Early retirement benefit*. If a plan provides for payment of an early retirement benefit, a vested participant who terminates his employment after having satisfied the service requirements, but not the age requirement for the early benefit, must be entitled, upon satisfaction of the age requirement, to receive a benefit not less than the benefit to which he would be entitled at normal retirement age, actuarially reduced in accordance with reasonable actuarial

1. See Treas. Reg. §1.416-1, M-12.
2. IRC Sec. 416(i)(4).
3. IRC Sec. 416(e).
4. Treas. Reg. §1.401-1(b)(2).
5. IRC Sec. 401(a)(12).
6. Treas. Reg. §1.414(l)-1.

assumptions.[1] In the case of a defined contribution plan, the employee, upon reaching early retirement age following termination after having satisfied service requirements, must be entitled to receive a benefit equal in value to the vested portion of his account balance at early retirement age.[2]

D. *Social Security offset*. The plan must not permit benefits to be reduced by reason of any increase in Social Security benefit levels or wage base occurring (1) after separation from service, in the case of a participant who has separated from service with nonforfeitable rights to benefits, or (if earlier) (2) after first receipt of benefits, in the case of a participant or beneficiary who is receiving benefits under the plan.[3] This requirement also applies to plans that supplement benefits provided under state or federal laws other than the Social Security Act, such as the Railroad Retirement Act of 1937.[4]

E. *Withdrawal of employee contributions*. The plan must preclude forfeitures of accrued benefits derived from employer contributions (whether forfeitable or nonforfeitable) solely because a benefit derived from the participant's contributions is voluntarily withdrawn by him after he has a nonforfeitable right to 50 percent of his accrued benefit derived from employer contributions.[5]

F. *Compensation*. Generally, a plan will not be qualified unless (for the purpose of any of the qualification rules) not more than $260,000 (as indexed for 2014, up from $255,000 in 2013) of annual compensation of any employee is taken into account under the plan for any plan year.[6] (See Appendix E for the amounts for earlier plan years.) This amount is indexed for inflation in increments of $5,000.[7]

Employees and Employers

3825. Who are treated as employees of an employer for purposes of meeting the qualification requirements?

"Employee" generally includes any individual who performs services for a person or entity that has the right to control and direct the individual's work, not only as to the result to be accomplished but also as to the details and means by which the result is accomplished.[8] These individuals are referred to as common law employees. The U.S. Supreme Court has set forth a twenty-factor test for determining whether an individual is a common law employee.[9] Self-employed individuals, including sole proprietors and partners operating trades, businesses, or professions, are treated as employees for purposes of participating in qualified plans even though they clearly are not common law employees (Q 3829).[10]

1. IRC Sec. 401(a)(14); Treas. Reg. §1.401(a)-14(c).
2. TIR 1334 (1/8/75), M-3.
3. IRC Sec. 401(a)(15).
4. Treas. Reg. §1.401(a)-15(d).
5. IRC Sec. 401(a)(19); Treas. Reg. §1.401(a)-19(b).
6. IRC Sec. 401(a)(17)(A); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
7. See IRC Sec. 401(a)(17)(B); Treas. Reg. §1.401(a)(17)-1(a).
8. Treas. Reg. §31.3121(d)-1(c)(2); *Packard v. Comm.*, 63 TC 621 (1975).
9. See *Nationwide Mutual Ins. Co. v. Darden*, 503 U.S. 318 (1992).
10. IRC Sec. 401(c)(1).

To prevent abuses of the tax advantages of qualified retirement plans through the manipulation of separate employer entities, the IRC provides several special rules that generally must be applied when testing plan qualification, as follows:

(1) All employees of all corporations that are members of a controlled group of corporations and all employees of trades or businesses under common control must be treated as employed by a single employer (Q 3830).[1]

(2) All employees of the members of an affiliated service group must be treated as employed by a single employer (Q 3832).[2]

(3) Leased employees must be treated as employees (Q 3826).[3]

The aggregation rules for controlled groups and trades and businesses under common control also appear in ERISA; the aggregation rules for affiliated service groups do not. Except in the case of employees of an affiliated service group or certain leased employees, employees of a partnership need not be treated as employees of any partner who does not own more than a 50 percent interest in the capital or profits of the partnership.[4]

3826. What special rules apply to leased employees for purposes of the qualification requirements?

For the IRC's qualification requirements, an employer generally treats any individual who is a leased employee as though that individual were the employer's own employee. To the extent that contributions or benefits provided for a leased employee by the organization from which the employee is leased are attributable to services performed for the employer, these contributions or benefits are treated as if they were provided by the employer under a qualified plan.[5] These two requirements have the effect of requiring most leased employees who have met a recipient plan's eligibility provisions to be included in the recipient's plan as an employee of the recipient.

A leased employee is an individual who is not an employee of the recipient employer and who performs services for a recipient employer, if the individual's services are provided to the recipient under one or more agreements with a leasing organization, the individual has performed services for the recipient or related employer on a substantially full-time basis for a period of at least one year, and the services are performed under the primary direction or control by the recipient employer.[6] For purposes of this definition, the term employee means a common law employee as determined under the twenty factor test set forth in *Nationwide Mutual Ins. Co. v. Darden*,[7]

1. IRC Secs. 414(b), 414(c); Treas. Regs. §§1.414(b)-1, 1.414(c)-1 to 1.414(c)-5.
2. IRC Sec. 414(m); Prop. Treas. Reg. §1.414(m)-1.
3. IRC Sec. 414(n).
4. See *Garland v. Comm.*, 73 TC 5 (1979); *Thomas Kiddie, M.D., Inc. v. Comm.*, 69 TC 1055 (1978).
5. IRC Sec. 414(n)(1).
6. IRC Sec. 414(n)(2).
7. 503 U.S. 318 (1992).

which must be applied before it can be determined whether an individual meets the definition of a "leased employee."[1]

The fact that an individual is a leased employee does not automatically mean he or she must be a participant in a plan maintained by the employer. A plan may exclude a leased employee from participation in the plan when the plan can satisfy coverage and nondiscrimination testing by including the leased employee with no benefits or the benefits provided by the leasing company plan. At least two circuit courts have held that ERISA does not *per se* require the inclusion of leased employees in an employer's plan.[2] In addition, the IRS addressed this issue in Notice 84-11,[3] stating that leased employees should be treated as employees, but the plan's failure to include them as participants in the plan does not result in disqualification of the plan. Despite its issuance prior to TRA '86, Notice 84-11 was cited favorably in *Bronk v. Mountain States Tel. & Tel., Inc.*,[4] as controlling authority on this issue.

The determination of whether services are performed under the primary direction or control of the recipient is based on the facts and circumstances. A finding will be made if the service recipient exercises the majority of direction and control over the individual; for example, whether the individual is required to comply with the recipient's instructions as to when, where, and how the services are to be performed; whether the services will be performed by a particular person; whether the individual is subject to the recipient's supervision; and whether the services must be performed in a particular order or sequence set by the recipient.

The recipient may be a single employer or a group consisting of employers required to be aggregated under the controlled group, common control, or affiliated service group rules (Q 3830, Q 3832).[5] Employers are related if a loss on a sale of property between them would be disallowed as a deduction under IRC Sections 267 or 707(b) or they are members of the same controlled group of corporations, using a 50 percent rather than 80 percent ownership test.[6]

Safe Harbor

Even though an individual is a leased employee, he or she may be disregarded by the employer for purposes of determining qualification if the individual is covered by a qualified money purchase pension plan maintained by the leasing organization and:

(1) the plan provides for employer contributions by the leasing organization at a non-integrated rate which is not less than 10 percent;

(2) the plan provides for immediate participation on the first day an individual becomes an employee of the leasing organization unless (x) the individual's compensation

1. *Burrey v. Pacific Gas and Elect. Co.*, 1998 U.S. App. Lexis 26594 (9th Cir. 1998); General Explanation of Tax Legislation Enacted in the 104th Congress (JCT-12-96), p. 173 (the 1996 Blue Book).
2. See *Abraham v. Exxon Corp.*, 85 F.3d 1126 (5th Cir. 1996); *Bronk v. Mountain States Tel. & Tel., Inc.*, 21 EBC 2862 (10th Cir. 1998), *aff'd*, 2000 U.S. App. LEXIS 14677 (10th Cir. 2000).
3. 1984-2 CB 469, A-14.
4. 21 EBC 2862 (10th Cir. 1998).
5. IRC Sec. 414(n)(6)(B).
6. IRC Secs. 414(n)(6)(A), 414(a)(3).

from the leasing organization in each plan year during the four year period ending with the plan year is less than $1,000, or (y) the individual performs substantially all of his or her services for the leasing organization;

(3) the plan provides for full and immediate vesting of all contributions under the plan; and

(4) leased employees do not constitute more than 20 percent of the recipient's non-highly compensated work force.[1]

This safe harbor applies only for purposes of the leased employee provision; it does not permit an employer to disregard a common law employee who otherwise meets the definition of a leased employee.[2]

A recipient's non-highly compensated work force is the aggregate number of individuals who are not highly compensated (Q 3827) but who are common law employees of the recipient and have performed services for the recipient on a substantially full-time period of at least one year or who are leased employees with respect to the recipient.[3]

A money purchase pension plan of a leasing organization is not qualified if it covers any individuals who are leased by the leasing organization to the recipient but who are not themselves employees of the leasing organization. That is because the plan would not meet the "exclusive benefit" rule (Q 3759).[4]

3827. Who are highly compensated employees for purposes of the qualification requirements?

Status as a highly compensated employee is determined by focusing on the determination year (i.e., the plan year for which the determination is being made) and the immediately preceding twelve month period (the "look-back" year).

An employee is a highly compensated active employee with respect to a plan year (i.e., the determination year) if the employee (1) was a 5 percent owner, as defined for top-heavy purposes (Q 3828), at any time during either the determination year or look-back year, or (2) received compensation for the preceding year in excess of $115,000 (in 2012-2014, as indexed, up from $110,000 in 2011) from the employer.

The compensation element of this determination can be limited to the top 20 percent of employees ranked by compensation (the "top-paid group").[5] The income threshold ($115,000 for 2014) is indexed at the same time and in the same manner as the Section 415 defined benefit dollar limitation.[6]

1. IRC Sec. 414(n)(5).
2. IRC Sec. 414(n)(2). See *Burnetta v. Comm.*, 68 TC 387 (1977), *acq.* 1978-2 C.B. 1.
3. IRC Sec. 414(n)(5)(C)(ii).
4. See *Professional & Executive Leasing, Inc. v. Comm.*, 89 TC 225 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988).
5. IRC Sec. 414(q)(1).
6. IRC Sec. 414(q)(1). See Temp. Treas. Reg. §1.414(q)-1T, A-3(c)(1); Notice 2011-90 (Nov. 21, 2011); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).

The applicable dollar amount for a particular determination or look-back year is the dollar amount for the calendar year in which the determination year or look-back year begins.[1]

Employers may identify the employees who are highly compensated employees under IRC Section 414(q) using the same snapshot testing that is used for the non-discrimination requirements (i.e., test results for a single day during the plan year, provided that that day is representative of the employer's workforce and the plan's coverage throughout the plan year).[2]

The IRS has stated that a fiscal year plan may make a calendar year data election. If the election is made, the calendar year beginning with or within the look-back year will be treated as the employer's look-back year for purposes of determining whether an individual is a highly compensated employee on account of his or her compensation. This election will not apply in determining whether a 5 percent owner is highly compensated. The effect of this election is that even though an employer maintains a plan on a fiscal year basis, it uses calendar year data. Once made, the election applies for all subsequent years unless changed by the employer.[3]

Top-Paid Group

An alternative way to determine highly compensated employees is to make a "top-paid group" election. The top-paid group election must be made in the plan document. The top-paid group of employees for a year is the group of employees in the top 20 percent, ranked on the basis of compensation paid for the year.[4]

Once made, a top-paid group election remains in effect until the employer changes it via plan amendment.[5] Former employees are not included in the top-paid group. Also, employees who are excluded under the collective bargaining agreement exclusion in determining the number of employees in the top-paid group also are excluded for purposes of identifying the members of the top-paid group.[6]

In determining the number of employees in the top-paid group (but not for the purpose of identifying the particular employees in the group), the following employees may be excluded:[7]

(1) employees with less than six months of service, including any service in the immediately preceding year;

(2) employees who normally work fewer than 17½ hours per week, if certain requirements are met;[8]

1. Temp. Treas. Reg. §1.414(q)-1T, A-3(c)(2); Information Letter to Kyle N. Brown dated December 9, 1999.
2. Rev. Proc. 93-42, 1993-2 CB 540, as modified by Rev. Proc. 95-34, 1995-2 CB 385.
3. Notice 97-45, 1997-2 CB 296.
4. IRC Sec. 414(q)(3).
5. Notice 97-45, 1997-2 CB 296.
6. Temp. Treas. Reg. §1.414(q)-1T, A-9(c).
7. IRC Sec. 414(q)(5); Temp. Treas. Reg. §1.414(q)-1T, A-9(b).
8. See Temp. Treas. Reg. §1.414(q)-1T, A-9(e).

(3) employees who normally work during not more than six months in any year, determined on the basis of the facts and circumstances as evidenced by the employer's customary experience in the years preceding the determination year;[1]

(4) employees under the age of 21; and

(5) employees covered by a collective bargaining agreement if 90 percent or more of the employees of the employer are covered under the agreement and the plan being tested covers only employees who are not covered under the agreement.[2]

An employer may elect to use a shorter period of service, smaller number of hours or months, or lower age than those specified above (including no age or service requirement exclusion).[3] Also, an employer may elect not to exclude members under the collective bargaining exclusion.[4]

No special notification or filing of a top-paid group election or a calendar year data election is required, although certain plan amendments may be necessary to incorporate a definition of highly compensated employees that reflects the election.[5] Furthermore, a consistency requirement states generally that an election made by an employer operating more than one plan must apply consistently to all plans of the employer that begin with or within the same calendar year.[6]

Nonresident aliens who receive no earned income from sources within the United States are disregarded for all purposes in determining the identity of highly compensated employees.[7] An employer may adopt any rounding or tie-breaking method that is reasonable, nondiscriminatory, and uniformly and consistently applied.[8] An employee who is highly compensated as a result of meeting two or more of the tests above is not disregarded for the purpose of applying any of those tests to other individuals.[9]

Compensation is the compensation received by the participant from the employer for the year, including elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement, or a tax sheltered annuity.[10]

A highly compensated former employee for a determination year is any employee who had a separation year prior to the determination year and was a highly compensated active employee for either his or her separation year or any determination year ending on or after his or her fifty-fifth birthday.[11]

1. See Temp. Treas. Reg. §1.414(q)-1T, A-9(f).
2. Temp. Treas. Reg. §1.414(q)-1T, A-9(b).
3. IRC. Sec. 414(q)(5). See Temp. Treas. Reg. §1.414(q)-1T, A-9(b)(2)(i).
4. Temp. Treas. Reg. §1.414(q)-1T, A-9(b)(2)(ii).
5. Notice 97-45, 1997-2 CB 296.
6. Notice 97-45, 1997-2 CB 296.
7. IRC Sec. 414(q)(8).
8. Temp. Treas. Reg. §1.414(q)-1T, A-3(b).
9. Temp. Treas. Reg. §1.414(q)-1T, A-3(d).
10. IRC Sec. 414(q)(4); Temp. Treas. Reg. §1.414(q)-1T, A-13.
11. Temp. Treas. Reg. §1.414(q)-1T, A-4.

A separation year is any year during which the employee separates from service with the employer. For purposes of this rule, an employee who performs no services for the employer during a determination year is treated as having separated from service with the employer in the year that he or she last performed services for the employer. An employee will be deemed to have a separation year if, in a determination year prior to attainment of age 55, the employee receives compensation in an amount less than 50 percent of his or her average annual compensation for the three consecutive calendar years preceding the determination year in which the employee received the greatest amount of compensation from the employer (or the total period of the employee's service with the employer, if less).

Because an employee who is deemed to have a separation is still performing services for the employer during the determination year, the employee is treated as an active employee and the deemed separation year is relevant only for purposes of determining whether the employee will be a highly compensated former employee after he or she actually separates from service. An employee with a deemed separation year will not be treated as a highly compensated former employee by reason of the deemed separation year if the employee later has a significant increase in services and compensation and, thus, is deemed to have a resumption of employment.[1]

The controlled group, common control, and affiliated service group aggregation rules, as well as the employee leasing provisions, are applied before applying the highly compensated employee rules (Q 3826, Q 3830, and Q 3832).[2] The entity aggregation rules are not taken into account for purposes of determining who is a 5 percent owner. The separate lines of business rules also are not applicable in determining the highly compensated group.[3]

3828. Who is a key employee for purposes of the top-heavy rules for qualified plans?

A key employee for purposes of the top-heavy rules is any employee or, in some cases, a former or deceased employee who, at any time during the plan year containing the determination date for the plan year to be tested, is:

(1) an officer of the employer whose annual compensation from the employer exceeds $170,000 (as indexed for 2014, up from $165,000 in 2013; this amount is indexed for inflation in increments of $5,000);

(2) a more-than-5 percent owner of the employer, or

(3) a more-than-1 percent owner of the employer having annual compensation from the employer for a plan year in excess of $150,000; this amount is not indexed for inflation.[4] (As to when the determination date occurs, see Q 3818).

1. Temp. Treas. Reg. §1.414(q)-1T, A-5.
2. IRC Sec. 414(q)(7).
3. Temp. Treas. Reg. §1.414(q)-1T, A-6, A-8.
4. IRC Sec. 416(i); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013); Treas. Reg. §1.416-1, T-12.

The determination as to whether an individual is an officer is made on the basis of all facts and circumstances; job titles are disregarded. An officer is an administrative executive who is in regular and continuous service, not a nominal officer whose administrative duties are limited to special and single transactions.[1] Unincorporated associations, including partnerships and sole proprietorships, may have officers.[2]

In any case, the number of individuals treated as key employees because of their officer status is limited to the greater of three individuals or 10 percent of all employees, but in any event, not more than fifty.[3]

Those employees who can be excluded when determining the number of employees in the top-paid group for purposes of identifying an employer's highly compensated employees (Q 3827) also can be disregarded in determining the number of officers to be taken into account in identifying key employees.[4] It is unclear how ties in compensation should be resolved. Whether an individual is a key employee because of his or her officer status is determined without regard to whether the individual is a key employee for any other reason.[5]

An individual owns more than 5 percent of a corporate employer if the individual owns more than 5 percent of the outstanding stock of the corporation by value or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. In determining stock ownership, the attribution rules of IRC Section 318 apply, but stock is attributed from a corporation if a 5 percent rather than 50 percent ownership test is met. Only ownership in the particular employer is considered; the controlled group, common control, and affiliated service group aggregation rules of IRC Section 414 are disregarded. An individual owns more than 5 percent of a non-corporate employer if he or she owns more than 5 percent of the capital or profits interest in that employer. Rules similar to the attribution rules of IRC Section 318 apply for purposes of determining ownership in a non-corporate employer. The aggregation rules of IRC Section 414 are disregarded.[6]

The rules discussed in the previous paragraph also apply to determine whether an individual is a more-than-1-percent owner of the employer.[7] All employers who are under common control or who are members of a controlled or affiliated service group (Q 3830, Q 3832) are treated as one employer for the purpose of determining whether a more-than-1-percent owner has annual compensation from the employer in excess of $160,000.

Compensation, for purposes of identifying key employees generally, is the compensation taken into account for purposes of the IRC Section 415 limits on contributions and benefits. Any elective or salary reductions contributions made on behalf of an employee to a 401(k) cash

1. Treas. Reg. §1.416-1, T-13; Rev. Rul. 80-314, 1980-2 CB 152.
2. Treas. Reg. §1.416-1, T-15.
3. IRC Sec. 416(i), flush language.
4. IRC Secs. 416(i)(1), 414(q)(5).
5. Treas. Reg. §1.416-1, T-14.
6. IRC Sec. 416(i)(1)(B); Treas. Regs. §§1.416-1, T-17; 1.416-1, T-8.
7. Treas. Reg. §1.416-1, T-16.

or deferred plan, simplified employee pension, 403(b) tax sheltered annuity, or cafeteria plan are included as compensation for purposes of IRC Section 415.[1]

For purposes of determining an employee's ownership in the employer, the attribution rules of IRC Section 318 and the aggregation rules of IRC Section 414 apply.[2] If two employees have the same ownership interest in the employer, the employee who has the greater annual compensation from that employer will be treated as owning the larger interest.[3]

The terms employee and key employee include their respective beneficiaries.[4]

The term key employee is applied under various provisions of the IRC (e.g., IRC Sections 401(h), 415(l), and 419A). For these purposes, the term does not include any officer or employee covered by a governmental plan.[5] Thus, the separate accounting and nondiscrimination rules under those provisions do not apply to employees covered by governmental plans.

3829. Who is an owner-employee for purposes of the qualification requirements?

An owner-employee is an employee (Q 3749) who owns the entire interest in an unincorporated trade or business or, in the case of a partnership, owns more than 10 percent of either the capital interest or the profits interest in the partnership.[6] Even if a partnership agreement does not specify a more than 10 percent interest in profits for any partner, if the formula for dividing profits (e.g., based on a partner's earnings productivity during the year) in operation produced a distribution at the end of the year of more than 10 percent of profits to a partner, the Tax Court has ruled that he or she is an owner-employee for the year.[7]

An individual who owns the entire interest in an unincorporated trade or business is treated as his or her own employer.[8] Thus, a proprietor or sole practitioner who has earned income (Q 3749) can establish a qualified plan under which he or she is both employer and employee.

A partnership is treated as the employer of each partner who is an employee (Q 3749).[9] Thus, partners individually cannot establish a qualified plan for a firm, but the partnership can establish a plan in which the partners can participate.

Persons who are shareholder-employees in professional corporations or associations or in business corporations (including S corporations) are not self-employed individuals. These people participate in a qualified plan of the corporation as regular employees of the corporation.[10]

1. IRC Secs. 416(i)(1)(D), 414(q)(4), 415(c)(3).
2. Treas. Reg. §1.416-1, T-19.
3. IRC Sec. 416(i)(1)(A).
4. IRC Sec. 416(i)(5). Treas. Reg. §1.416-1, T-12.
5. IRC Sec. 416(i).
6. IRC Sec. 401(c)(3).
7. *Hill, Farrer & Burrill v. Comm.*, 67 TC 411 (1976), *aff'd*, 594 F.2d 1282 (9th Cir. 1979).
8. IRC Sec. 401(c)(4).
9. IRC Sec. 401(c)(4).
10. Treas. Reg. §1.401-1(b)(3).

This is true even of a shareholder-employee who is sole owner of the corporation. S corporation pass-through income may not be treated as self-employment earnings for purposes of a Keogh plan deduction, even where the shareholder performed services for the corporation.[1]

A common law employee is an employee under common law rules, as distinguished from a self-employed individual who is considered an employee only for qualified plan purposes. An individual generally is considered an employee under common law rules if the person or organization for whom the individual performs services has the right to control and direct his or her work not only as to the result to be accomplished, but also as to the details and means by which the result is accomplished.[2]

The common law rules also apply generally in determining whether an individual is an employee for Social Security purposes. Ordinarily, therefore, an individual who is an employee under Social Security is a common law employee for self-employed plan purposes.

A person's status for self-employed plan purposes is determined by the definition of employee under the Social Security law, irrespective of whether or how the person's earnings are covered under Social Security.

Thus, if a person is an employee under the common law rules, it is immaterial that his or her earnings are treated as self-employment income under the Social Security law. For example, a minister or other clergy who is employed by a congregation on a salaried basis is a common law employee, and not a self-employed individual, even though for Social Security purposes the person's compensation is treated as net earnings from self-employment. Amounts received by the minister directly from members of the congregation, such as fees for performing marriages, baptisms, or other personal services, represent earnings from self-employment.

Full-time life insurance salespersons are treated as common law employees for both Social Security and qualified retirement plan purposes even though, under the common law rules, they are self-employed. This is because of special statutory provisions in the Social Security Act and the IRC. Thus, a full-time life insurance sales person under the Social Security law is prohibited from establishing a qualified plan for himself or for herself.[3] It would appear, however, that general agents and most general lines insurance agents and brokers are considered self-employed individuals and are eligible to establish qualified plans for themselves and their employees.

Attorneys with a law firm, depending on the circumstances, can either be self-employed or have the status of an "employee" of the firm.[4]

An individual may participate in a qualified plan as a self-employed person even though the individual performs work as a common law employee for another employer. For example, an attorney who is a common law employee of a corporation and who in the evenings maintains

1. See *Durando v. U.S.*, 70 F.3d 548 (9th Cir. 1995).
2. Treas. Reg. §31.3121(d)-1(c)(2).
3. Treas. Reg. §1.401-10(b)(3). See also IRC Sec. 7701(a)(20); IRS Pub. 560.
4. See Rev. Rul. 68-324, 1968-1 CB 433.

an office in which he or she practices law is eligible to establish a plan as a self-employed person with respect to the law practice.

An individual may be self-employed with respect to some services the individual sells to a business even though he or she also provides other services to the same business as an employee. In either case, the individual may participate in a qualified plan as a self-employed person with respect to his or her self-employed earnings, even though the employer maintains a qualified plan under which the individual is covered as a common law employee.[1] A tenured university professor who conducted seminars in a separate capacity at the university with which he was employed was determined by the Tax Court to be self-employed, despite objections by the IRS. As a result, he was permitted to establish a Keogh plan with amounts earned from his self-employment.[2]

3830. What is a controlled group of corporations?

The term controlled group is used to determine who makes up the group of employees that will be subject to the IRC's coverage, nondiscrimination testing, and most qualification requirements. All employees of a single employer generally are included in this testing. The controlled group rules aggregate several entities (e.g., partnerships, sole proprietorships, and corporations) into a single employer for meeting various qualification requirements of the IRC. All employees of a group of employers that are members of a controlled group of corporations or, in the case of partnerships and proprietorships, are under common control will be treated as employed by a single employer.[3] In general, the determination of whether a group is a controlled group of corporations or under common control is based on stock ownership by value or voting power.

A controlled group may be a parent-subsidiary controlled group, a brother-sister controlled group, or a combined group.[4]

A parent-subsidiary controlled group is composed of one or more chains of subsidiary corporations connected through stock ownership with a common parent corporation. A parent-subsidiary group exists if at least 80 percent of the stock of each subsidiary corporation is owned by one or more of the other corporations in the group and the parent corporation owns at least 80 percent of the stock of at least one of the subsidiary corporations. When determining whether a parent owns 80 percent of the stock of a subsidiary corporation, all stock of that corporation owned directly by other subsidiaries is disregarded.

A brother-sister controlled group consists of two or more corporations in which five or fewer persons, individuals, estates, or trusts own stock consisting of 80 percent or more of each corporation and more than 50 percent of each corporation when taking into account each stockholder's interest only to the extent he or she has identical interests in each corporation.

1. *Pulver v. Comm.*, TC Memo 1982-437; Treas. Reg. §1.401-10(b)(3)(ii).
2. *Reece v. Comm.*, TC Memo 1992-335.
3. IRC Secs. 414(b), 414(c).
4. Treas. Reg. §1.414(b)-1.

For purposes of the 80 percent test, a stockholder's interest is considered only if he or she owns some interest in each corporation of the group.[1]

A combined group consists of three or more corporations, each of which is a member of a parent-subsidiary group or a brother-sister group and one of which is both a parent of a parent-subsidiary group and a member of a brother-sister group.[2]

Special rules apply for determining stock ownership, including special constructive ownership rules, when determining the existence of a controlled group.[3] Community property rules, where present, also apply.[4] For purposes of qualification, the test for a controlled group is strictly mechanical; once the existence of a group is established, aggregation of employees is required and will not be negated by showing that the controlled group and plans were not created or were manipulated for the purpose of avoiding the qualification requirements.[5]

3831. When are trades or businesses under common control?

Under the regulations, trades or businesses are under common control if they constitute a parent-subsidiary group of trades or businesses, a brother-sister group of trades or businesses, or a combined group of trades or businesses. The existence of these groups is determined under rules similar to those discussed in Q 3830 for controlled groups of corporations. "Trades or businesses" include sole proprietorships, partnerships, estates, trusts, and corporations.[6]

3832. What is an affiliated service group?

For purposes of certain qualification requirements, as well as for the vesting requirements, top-heavy rules, Section 415 limits and the requirements for SEPs, all employees of the members of an affiliated service group generally are treated as employed by a single employer.[7]

An affiliated service group is a group consisting of a service organization (referred to as "FSO" for "first service organization") and:

(1) an additional service organization (referred to as an "A" organization) that is a shareholder or partner in an FSO and that regularly performs services for the FSO or that is regularly associated with the FSO in the performance of services for third parties, or

(2) an organization (referred to as a "B" organization) if a significant portion of the organization's business is the performance of services for an FSO or for an A organization (or both) and the services are of a type historically performed by employees in the service field of the FSO or A organization; and

1. *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982); Treas. Reg. §1.1563-1(a)(3).
2. IRC Secs. 414(b), 1563; Treas. Reg. §1.414(b)-1.
3. IRC Sec. 1563(d); Treas. Reg. §1.414(b)-1.
4. *Aero Indus. Co., Inc. v. Comm.*, TC Memo 1980-116.
5. *Fujinon Optical, Inc. v. Comm.*, 76 TC 499 (1981).
6. IRC Sec. 414(c); Treas. Regs. §§1.414(c)-1, 1.414(c)-2, 1.414(c)-3, 1.414(c)-4.
7. IRC Sec. 414(m)(1).

(3) 10 percent or more (in the aggregate) of the interests in the B organization is held by highly compensated employees of an FSO or an A organization or certain common owners.[1]

The term affiliated service group also includes a group consisting of (1) an organization the principal business of which is performing management functions for another organization on a regular and continuing basis, and (2) the organization for which the functions are performed.[2]

An organization is a service organization if its principal business is the performance of services in one of the fields enumerated in the regulations (e.g., health, law, etc.) or if capital is not a material income-producing factor for the organization.[3]

The performance of services for a first service organization or for an A organization (or both) will be assumed to constitute a significant portion of a B organization's business if 10 percent or more of its total gross receipts from all sources during the current year, or two preceding years, was derived from performing services for such organization or organizations. It will be assumed that the performance of services for such organization or organizations is not a significant portion of a B organization's business if less than 5 percent of its gross receipts derived from performing services during the current year and two preceding years was derived from performing services for such organizations.[4] Services are of a type historically performed by employees in a particular field if it was not unusual for the services to be performed by employees of organizations in that service field in the United States on December 13, 1980.[5]

The principles of the constructive stock ownership rules of IRC Section 318(a) apply. Thus, ownership generally will be attributed to an individual from the individual's spouse, children, grandchildren and parents, between a partner and the partnership, between a trust or estate and its beneficiaries, and between a corporation and a more-than-50 percent shareholder, including a corporate shareholder.[6]

Two or more affiliated service groups will not be aggregated merely because an organization is an A organization or a B organization with respect to each affiliated service group. All organizations that are A organizations or B organizations with respect to a single FSO, together with that FSO, must be treated as a single affiliated service group.[7]

Taxpayers may rely on the proposed regulations covering service-type affiliated groups until final rules are published. Examples explaining the tests for a service-type affiliated service group can be found in Revenue Ruling 81-105.[8]

1. IRC Sec. 414(m); Prop. Treas. Reg. §1.414(m)-2(c)(1).
2. IRC Sec. 414(m)(5).
3. IRC Sec. 414(m)(3); Prop. Treas. Reg. §1.414(m)-2(f). See Rev. Rul. 81-105, 1981-1 CB 256.
4. Prop. Treas. Reg. §1.414(m)-2(c)(2).
5. Prop. Treas. Reg. §1.414(m)-2(c)(3).
6. IRC Sec. 414(m)(6)(B).
7. Prop. Treas. Reg. §1.414(m)-2(g).
8. 1981-1 CB 256.

Retroactive Disqualification

3833. Can the IRS retroactively apply a finding that a plan does not meet qualification requirements?

Yes. The IRS may retroactively revoke a plan's determination letter by notice to the taxpayer if:

1. there has been a change in the applicable law,

2. the organization omitted or misstated a material fact,

3. the organization has operated in a manner materially different from that originally represented, or,

4. in the case of organizations to which IRC Section 503 applies, the organization engaged in a prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purpose, and such transaction involved a substantial part of the corpus or income of such organization.[1]

The IRS has broad discretion to determine the extent to which rulings and regulations will be given retroactive effect.[2] The wide array of correction procedures established by the IRS in the past decade offers a choice of less severe remedies, however, and suggests that the IRS is reluctant to disqualify plans except under the most egregious circumstances.

The IRS also may retroactively correct its own mistaken application of law, even where a taxpayer may have relied to the taxpayer's detriment on the IRS's mistake.[3] Concerning determination letters, the IRS has voluntarily limited its authority by the issuance of revenue procedures stating the standards by which the continuing effect of a determination letter will be judged. In substance, there are two standards.

First, if a published revenue ruling is issued that is applicable to a previously approved plan, to retain its qualified status the plan must be amended to conform with that ruling before the end (and effective at least as of the beginning) of the first plan year following the one in which the ruling was published.[4] Thus, with respect to the approved plan, the revenue ruling is not given retroactive effect and becomes effective only at the beginning of the next plan year.[5]

Second, if no applicable published ruling affecting the qualification of the plan has intervened between the approval and the revocation of the approval, the revocation ordinarily will

1. Rev. Proc. 2014-9, 2014-2 IRB 281. See also Tax Consequences of Plan Disqualification at http://www.irs.gov/Retirement-Plans/Tax-Consequences-of-Plan-Disqualification.
2. *Automobile Club of Mich. v. Comm.*, 353 U.S. 180 (1957); IRC Sec. 7805(b).
3. *Dixon v. U.S.*, 381 U.S. 68 (1965).
4. Rev. Proc. 93-6, 1993-1 CB 430, at Sec. 22.
5. See also *Wisconsin Nipple and Fabricating Corp. v. Comm.*, 581 F.2d 1235 (7th Cir. 1978).

not have retroactive effect with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability was directly involved in such ruling if:

(1) there has been no misstatement or omission of material facts,

(2) the facts subsequently developed are not materially different from the facts, on which the ruling was based,

(3) there has been no change in the applicable law,

(4) the ruling originally was issued with respect to a prospective or proposed transaction, and

(5) the taxpayer directly involved in the ruling acted in good faith in reliance on the ruling and a retroactive revocation would be to the taxpayer's detriment.[1]

Employer Deduction

3834. How is an employer's deduction limited for qualified plan contributions ?

The amount of an employer's deduction for contributions to a qualified plan depends on the type of plan being maintained. The maximum amounts an employer may deduct are explained at Q 3683 for pension plans, Q 3695 for profit sharing or stock bonus plans, and Q 3746 for employee stock ownership plans ("ESOPs"). If an employer contributes to two or more plans covering any common participants, it is subject to the limits explained in Q 3839.

Rules that govern the timing of an employer's deduction are explained at Q 3836. Other more specific requirements that may affect an employer's ability to deduct contributions or plan expenses are explained at Q 3837.

Special rules governing contributions of property are explained at Q 3835. The 10 percent penalty on nondeductible contributions is explained at Q 3840.

3835. Can an employer contribute property other than money to a qualified plan trust?

The U.S. Supreme Court has held that an employer's transfer of unencumbered property to a defined benefit plan in satisfaction of a funding obligation is a prohibited transaction.[2] The Court left open the question of whether a transfer of unencumbered property that is not in satisfaction of a funding obligation might be permissible without violating prohibited transaction rules.

1. Rev. Proc. 2014-9, 2014-2 IRB 281., Sec. 12.01. See also *Churchill, Ltd. Emple. Stock Ownership Plan & Trust v. Comm'r*, T.C. Memo 2012-300 (2012), *pet. denied*, 2013 U.S. App. LEXIS 11046 (8th Cir. May 29, 2013); *Lansons, Inc. v. Comm.*, 622 F.2d 774 (5th Cir. 1980); *Oakton Distributors, Inc. v. Comm.*, 73 TC 182 (1979); *Pittman Construction v. U.S.*, 436 F. Supp. 1215 (E.D. La. 1977).

2. *Keystone Consol. Indus., Inc. v. Comm.*, 113 S.Ct. 2006 (1993).

The Department of Labor has expressed the view that a contribution of property other than cash that reduces a sponsor's funding obligation would be a prohibited transaction in the absence of a statutory or administrative exemption, whether it is made to a defined benefit or a defined contribution plan; a contribution in excess of amounts needed to meet a plan's funding requirements may be permissible, provided that acceptance of the contribution is consistent with the general standards of fiduciary conduct under ERISA.[1]

Certain contributions of employer stock are exempt from the prohibited transaction rules (Q 3871). Furthermore, there is an administrative exemption for the contribution of a life insurance policy to a plan if certain conditions are met (Q 3865). This exemption also protects self-employed owner-employees and more-than-5-percent shareholder-employees of S corporations from the prohibited transaction rules of Title I of ERISA (Q 3871).[2] If only a sole proprietor or partners and their spouses participate in the plan, Title I of ERISA does not apply.[3]

A contribution of an employer's promissory note to a trust does not constitute payment and no deduction is allowable until the note is paid.[4] The IRS has taken the position that the contribution of an employer's own term promissory note is a prohibited transaction.[5]

Planning Point: One way to deal with a plan's inability to distribute illiquid assets may be for the plan to contribute the illiquid assets to a separate trust and distribute certificates of interest in that trust to its participants as part of their lump sum distributions. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC*.

A sale by plan fiduciaries of some of their customers' promissory notes to a plan was a prohibited transaction, notwithstanding the fact that the notes generated a competitive rate of return.[6] An earlier letter ruling indicated that a contribution of a third party promissory note was payment and that its fair market value could be deducted.[7] Contribution of a check is only conditional payment; if the check is not paid, the deduction will be disallowed.[8]

The fair market value of contributed property is considered to be the amount contributed for purposes of calculating annual additions within the overall Section 415 limits (Q 3784, Q 3668, and Q 3677).[9]

For special rules applying to the sale of employer securities to a defined contribution plan, see Q 3679. The requirements for a Section 1042 election upon the sale of employer stock to an ESOP are explained at Q 3742.

1. DOL Interpretive Bulletin 94-3, 59 Fed. Reg. 66735 (Dec. 28, 1994).
2. PTE 92-5, 57 Fed. Reg. 5019, (formerly PTE 77-7, 1977-2 CB 423).
3. See Labor Reg. §2510.3-3.
4. Rev. Rul. 55-608, 1955-2 CB 546; Rev. Rul. 80-140, 1980-1 CB 89; *Don E. Williams Co. v. U.S.*, 429 U.S. 569 (1977).
5. Rev. Rul. 80-140, 1980-1 CB 89.
6. See *Westoak Realty and Inv. Co., Inc. v. Comm.*, 999 F. 2d 308, 93-2 USTC ¶50,395 (8th Cir. 1993).
7. Let. Rul. 7852116.
8. *Springfield Prod., Inc., v. Comm.*, TC Memo 1979-23.
9. Treas. Reg. §1.415(c)-1(b)(4).

3836. When may an employer take a deduction for its contributions to a pension, profit sharing, or stock bonus plan?

An employer's contribution generally is deductible only in the taxable year it is paid, except for certain carry-forwards (Q 3683).[1] Both cash and accrual basis employers, including self-employed individuals, are deemed to have made a contribution in the preceding tax year if the payment is on account of that year and is made no later than the due date, including extensions, of the employer's tax return.[2]

In contrast, minimum funding rules may require that a contribution be made earlier than the time at which it is deductible (Q 3687.)

A payment will be considered made on account of the preceding tax year if the plan treats it as if received on the last day of that year and either the employer designates, in writing, that the payment is made on account of the previous year or the employer claims it as a deduction on its tax return for the preceding tax year. This kind of designation is irrevocable.[3] See Q 3673 for requirements of quarterly estimated contribution payments applicable to certain plans.

A delayed payment is deductible for the prior year only if the payment would have been deductible had it actually been made on the last day of the prior taxable year.[4] Thus, where an employer's taxable year ended June 30 and the plan year ended December 31, the employer could not deduct elective deferrals and matching contributions attributable to compensation earned by plan participants after June 30 because the contributions were not compensation for services rendered in the prior taxable year of the employer (Q 3837).[5]

Where an employer's taxable year ended January 31, 1998, and the plan year was the calendar year, the employer could deduct elective deferrals and matching contributions attributable to compensation earned by plan participants during January 1998 on its return for its fiscal year ending January 31, 1998, even though that was the first month of the 1998 plan year.[6]

Regulations under IRC Section 401(k) provide that contributions made in anticipation of future performance of services generally will not be treated as elective contributions; thus, no deduction is available for these amounts. The regulations essentially make it clear that contributions made pursuant to a cash or deferred election must be made after the employee's performance of services with respect to which the compensation is payable (Q 3698).[7]

The liability to make a contribution need not have accrued in the preceding year, but the plan must have been in existence before the end of the preceding tax year.[8] Likewise, the trust

1. IRC Sec. 404(a).
2. IRC Sec. 404(a)(6). See, e.g., Let. Rul. 199935062.
3. Rev. Rul. 76-28, 1976-1 CB 106, as modified by Rev. Rul. 76-77, 1976-1 CB 107.
4. Rev. Rul. 90-105, 1990-2 CB 69; *Lucky Stores, Inc. v. Comm.*, 153 F.3d 964 (9th Cir. 1998).
5. Rev. Rul. 90-105, 1990-2 CB 69. See also *American Stores Co. v. Comm.* 108 TC 178 (1997), *aff'd*, 170 F.3d 1267 (10th Cir. 1999).
6. CCA 200038004, 2000 IRS CCA LEXIS 101.
7. See Treas. Reg. §1.401(k)-1(a)(3)(iii).
8. Rev. Rul. 76-28, as modified by 76-77, 1976-1 CB 107; *Engineered Timber Sales, Inc. v. Comm.*, 74 TC 808 (1980), *appeal dismissed* (5th Cir. 1981).

must be in existence within the taxable year for which deductions for contributions are claimed (Q 3758).[1] If a plan trust is complete in all respects on the last day of the taxable year except that it has no corpus, the trust is deemed to have been in existence in the taxable year if the initial contribution is made within the grace period.[2]

In the case of a non-trusteed annuity plan evidenced only by a contract with an insurance company, the plan is not in effect until the contract is executed and issued. Where the plan is separate from the insurance contract, the plan will be considered in effect by the close of the taxable year if:

(1) the contract has been applied for and the application accepted by the insurance company,

(2) a contract or abstract has been prepared outlining the terms of the plan,

(3) a part payment of premium has been made, and

(4) the plan has been communicated to the employees.[3]

If the plan year of a defined benefit plan and the employer's tax year are not the same, the employer may claim a deduction for a contribution made for the plan year that either ends or begins in the tax year or may use a weighted average such as the number of months in each plan year falling in the tax year. The same method must be used consistently.[4]

Where a short taxable year with no plan year beginning or ending within it resulted when an employer changed its taxable year to a calendar year, the IRS approved a method giving the employer a prorated deduction for the length of the short year.[5]

3837. What other specific rules affect an employer's deduction for its contributions to a qualified plan?

If a plan is qualified, an employer may deduct its contributions currently, regardless of whether the rights of the individual participants are forfeitable or non-forfeitable.[6] To be deductible, a contribution on behalf of a participant must qualify as reasonable compensation for services actually rendered to the contributing employer by the participant as an employee.[7] The IRS has discussed the limitations on deductions and carryovers for contributions to a qualified profit sharing plan when an employee's total compensation is unreasonable.[8]

1. *Catawba Indus. Rubber Co. v. Comm.*, 64 TC 1011 (1975); *Attardo v. Comm.*, TC Memo 1991-357.
2. Rev. Rul. 81-114, 1981-1 CB 207.
3. Rev. Rul. 59-402, 1959-2 CB 122; *Becker v. Comm.*, TC Memo 1966-55.
4. Treas. Reg. §1.404(a)-14(c).
5. See Let. Rul. 8806053.
6. IRC Sec. 404.
7. IRC Sec. 404(a); *Thousand Oaks Residential Care Home I, Inc. v. Comm'r*, TC Memo 2013-10 (2013); *Bianchi v. Comm.*, 66 TC 324 (1976), *aff'd*, 553 F.2d 93 (2d Cir. 1977); *La Mastro v. Comm.*, 72 TC 377 (1979); *Edwin's Inc. v. U.S.*, 501 F.2d 675 (7th Cir. 1974); *Chas. E. Smith & Sons Co. v. Comm.*, 184 F.2d 1011 (6th Cir. 1950); *Bardahl Mfg. Co. v. Comm.*, TC Memo 1960-223; *Acme Pie Co. v. Comm.*, 10 TCM (CCH) 97 (1951).
8. Rev. Rul. 67-341, 1967-2 CB 156.

Where reasonableness of compensation was not in question, the Tax Court ruled that a newly formed corporation could deduct its full contribution to a defined benefit plan for the plan year that began in the corporation's short first tax year and it rejected the IRS argument that only 4.5/12 of the contribution should be deductible because the short year was only 4½ months long.[1]

Deductions with respect to a multiemployer plan maintained pursuant to a collective bargaining agreement are determined as if all participants were employed by a single employer.[2] In the case of a multiple employer plan, the deduction limit generally is applied as if each employer maintained a separate plan.[3] Different rules apply to a plan adopted by two or more corporations that are members of the same controlled group (Q 3830); in that case, the deduction limits are determined as if all such employers were a single employer.[4]

Deductions with respect to a CSEC plan are determined as if all participants were employed by a single employer.[5]

Certain employer liability to the Pension Benefit Guaranty Corporation ("PBGC") as a result of plan termination or withdrawal from a multiemployer plan will be treated as a contribution to be deducted when paid without regard to the usual limits on the deduction of employer contributions to qualified plans.[6]

Contributions to fund post-retirement medical benefits under IRC Section 401(h) for common law employees may be deducted currently by an employer if they are reasonable, ascertainable, and distinct from contributions to fund retirement benefits, provided the benefits are subordinate to the retirement benefits provided by the plan (Q 3751).[7] Contributions to fund post-retirement medical benefits are not taken into account in determining the amount deductible with respect to contributions for retirement benefits. The amount of any excess pension assets transferred in a "qualified transfer" (Q 3756) to an IRC Section 401(h) account is not deductible.[8]

Any allocable portion of past service and current pension costs that must be included in the basis of property produced by an employer or held for resale by the employer under the uniform capitalization rules is not deductible by the employer.[9]

3838. Are plan expenses deductible by an employer?

Broker fees paid by a qualified plan are not separately deductible by an employer and are subject to the deduction limits of IRC Section 404(a) (Q 3683, Q 3695).[10] Amounts that an

1. *Plastic Eng'g & Mfg. Co. v. Comm.*, 78 TC 1187 (1982).
2. IRC Sec. 413(b)(7); see Let. Rul. 8743077.
3. IRC Sec. 413(c)(6).
4. IRC Sec. 414(b).
5. IRC Sec. 413(d)(2).
6. IRC Sec. 404(g).
7. IRC Sec. 404(a)(2); Treas. Reg. §1.404(a)-3(f).
8. IRC Sec. 420(d)(1)(A).
9. OBRA '87, Sec. 10204. See also Notice 88-86, 1988-2 CB 401, obsoleted by TD 8897, 2000-2 CB 234.
10. Rev. Rul. 86-142, 1986-2 CB 60.

employer reimburses a plan trustee for amounts paid to an investment manager to manage and invest plan assets also are not deductible under IRC Sections 162 or 212.

Amounts that an employer pays directly to an investment manager in connection with the management of a plan's assets apparently are deductible and are not treated as plan contributions under IRC Section 404.[1] The distinction appears to be that brokers' fees are directly related to the purchase of an asset and thus are part of the cost of the securities, but that investment managers' fees, as well as legal, accounting, and trustee fees, are recurring administrative expenses that do not vary with the number or volume of investment transactions.[2]

Some plans allocate plan expenses to the accounts of participants. The IRS has issued guidance permitting such plans to pay these expenses on behalf of active employees while charging the accounts of former employees their proportionate share of such expenses.[3]

3839. How much may an employer deduct if it contributes to more than one kind of qualified plan?

An employer that sponsors both a defined benefit and defined contribution plan covering any common participants may deduct no more than the greater of 25 percent of participant payroll paid in the employer's tax year or the contribution necessary to satisfy the minimum funding requirements for the plan year.[4] In the case of employer contributions to one or more defined contribution plans, this limitation applies only to the extent contributions exceed 6 percent of the compensation paid or accrued during the taxable year.[5]

This combined limit does not apply if the only amounts contributed to the defined contribution plan are elective deferrals (Q 3697, Q 3698, Q 3705).[6] Nonetheless, contributions or benefits may not be deducted in the year of contribution to the extent that they exceed the Section 415 limits (Q 3668, Q 3677, Q 3784), even if they are required by the minimum funding requirements.[7] The excess may be deducted in succeeding years as a contribution carry-over, but see Q 3840 for an excise tax on nondeductible contributions. The deduction for current contributions and carryovers in a tax year cannot exceed 25 percent of aggregate compensation (Q 3695).[8]

For purposes of the deduction limitations, a Section 412(i) fully insured plan (Q 3734, Q 3735) is treated as a defined benefit plan (Q 3683).[9] In plan years beginning after December 31, 2007, contributions to defined benefit plans insured by the PBGC will be excluded from the combined plan limit.[10]

1. See Let. Ruls. 9124036, 9124035, 8941009, 8940013.
2. Let. Rul. 9252029.
3. See Rev. Rul. 2004-10, 2004-7 IRB 484.
4. IRC Sec. 404(a)(7)(A).
5. See IRC Sec. 404(a)(7)(C)(iii).
6. IRC Sec. 404(a)(7)(C)(ii).
7. IRC Sec. 404(j); Notice 83-10, 1983-1 CB 536, F-3.
8. IRC Sec. 404(a)(7)(B).
9. IRC Sec. 404(a)(7)(D).
10. See IRC Sec. 404(a)(7)(C)(iv).

If no employee or former employee benefits under both plans, then the limits that would apply to such plans separately (Q 3683, Q 3695) are not reduced by this overall limit.[1]

Under earlier provisions, a simplified employee pension plan was treated as if it were a separate profit sharing or stock bonus plan for purposes of the overall 25 percent limit.[2] If an employer maintains both a simplified employee pension plan and a profit sharing or stock bonus plan, the 25 percent deductible limit applicable to qualified profit sharing and stock bonus plans must be reduced by the amount of any employer deduction for contributions to the simplified employee pension plan on behalf of a participant also covered under the profit sharing or stock bonus plan.[3] An employer sponsoring both a stock bonus and a profit sharing plan is considered to have a single plan.[4]

3840. Is there a penalty if an employer contributes more to its qualified plan than it can deduct in a year?

Yes, if the plan is a defined contribution plan.

The penalty for making nondeductible contributions also applied to defined benefit plans until the 2008 year. The employer is subject to a tax equal to 10 percent of the nondeductible amount (determined as of the close of the employer's tax year) made to a defined contribution plan (e.g., a pension, profit sharing, or stock bonus plan, a simplified employee pension plan, or a SIMPLE IRA plan).[5]

Nondeductible contributions are the sum of the amounts that the employer contributes to these plans in excess of the deduction limit for the taxable year plus the total amount of employer contributions for each preceding year that were not allowable as a deduction (Q 3683, Q 3695, Q 3836, Q 3839).

Regulations provide two exceptions to this penalty, although they have little practical application. They apply by reducing the nondeductible amounts by the sum of the portion of the amounts that is returned to the employer during the taxable year and the portion of the amounts that became deductible for a preceding taxable year or for the current year.[6] The amount allowable as a deduction for any taxable year is treated as coming first from carry-forwards from preceding taxable years, in chronological order, and then from contributions made during the taxable year.[7]

Defined benefit plan contributions generally are disregarded in determining whether an employer has made nondeductible contributions.[8] Contributions that are nondeductible solely because of the combined plan deduction limits are exempt from the excise tax to the extent

1. IRC Sec. 404(a)(7)(C).
2. IRC Sec. 404(h)(3).
3. IRC Sec. 404(h)(2).
4. Let. Rul. 7916102.
5. IRC Sec. 4972(a).
6. IRC Sec. 4972(c)(1).
7. IRC Sec. 4972(c)(2).
8. IRC Secs. 4972(c)(6), 4972(c)(7).

of the greater of (1) the amount of contributions not exceeding 6 percent of compensation or (2) the sum of matching contributions under IRC Section 401(m)(4)(A) plus elective deferrals under IRC Section 402(g)(3)(A) (Q 3705).[1]

Where amounts contributed in one year to satisfy the preceding year's funding requirement under a conditional waiver would exceed the deductible limit for that prior year, the employer was permitted to report some of those contributions as contributions for the current year for deduction purposes and avoid the nondeductible contributions penalty.[2]

Although the IRC allows the amount of excess contributions to be reduced by the withdrawal of the excess contribution, there are several restrictions for the return of employer contributions to the employer (Q 3759). Apparently, the penalty applicable to an excess contribution also is eliminated on plan termination because the plan no longer exists.

The excise tax does not apply in the case of a governmental plan or an employer that is exempt from income tax.[3] To the extent that an employer has been subject to unrelated business income tax, this exception is inapplicable.[4] Contributions by a tax-exempt employer that was part of a controlled group including at least one non-exempt employer were subject to the excise tax.[5]

If a self-employed individual contributes more than he or she is permitted to deduct in a year, the individual is subject to a tax penalty equal to 10 percent of nondeductible contributions under the plan determined as of the close of the individual's tax year. In the case of a plan that provides contributions or benefits for self-employed individuals, this tax is payable by the employer, which is the sole proprietor or the partnership.[6] Contributions required to meet the minimum funding standards are not subject to this tax even if the self-employed individual cannot deduct them because they exceed his or her earned income.[7]

Taxation of Distributions

3841. How are distributions taxes from a qualified plan?

Benefits distributed from a plan generally are included in the participant's income as ordinary income in the year received. Certain exceptions to the general rule apply based on the timing and nature (e.g., lump sum or periodic) of the distribution. These exceptions include:

(1) The taxation of certain lump sum distributions (Q 3862);

(2) Distribution of an annuity contract (Q 538);

(3) Distribution of certain employer securities that are distributed as a lump sum distribution (Q 3863);

(4) Distributions that are made as qualified Roth distributions;

1. IRC Sec. 4972(c)(6)(A).
2. Let. Rul. 9107033.
3. IRC Sec. 4972(d)(1)(B).
4. See Let. Ruls. 9622037; 9304033.
5. See Let. Rul. 9236026.
6. IRC Sec. 4972.
7. IRC Sec. 4972(c)(4).

(5) Distributions that consist in part of non-taxable basis (e.g., a participant loan in default that was treated as a deemed distribution, or the total employee after-tax contributions made to a plan); and

(6) Distributions that constitute eligible rollover distributions and that are rolled over to another plan or IRA.

The ordinary income taxation of plan distributions are discussed as follows:

(1) The taxation of periodic retirement payments (Q 539 and Q 3864);

(2) The taxation of disability payments (Q 368);

(3) The taxation of payments to beneficiaries (Q 3865 to Q 3867);

(4) The taxation of amounts received preretirement (Q 3859);

(5) Certain early or premature distributions that are subject to a 10 percent penalty (Q 3860);

(6) The treatment of amounts received post-retirement (Q 3861);

(7) Distribution of corrective distributions of excess contributions and excess aggregate contributions (Q 3733);

(8) Corrective distributions of excess deferrals (Q 3705).

Participant loans meeting certain IRC requirements are not treated as taxable distributions. Loans to employees that do not meet certain requirements (Q 3848 to Q 3854) will be taxed as deemed distributions.

Distribution to alternate payee. A spouse or other alternate payee under a qualified domestic relations order (Q 3816) is treated as a distributee for most purposes under rules relating to the taxation of distributions from qualified plans (Q 3862, Q 544).[1]

Planning Point: A divorcing or separating spouse who is negotiating a qualified domestic relations order and who has not attained age 59½ should weigh the relative advantages and disadvantages of a lump sum distribution that can be rolled over to an IRA in his or her own name and a series of distributions directly from his or her spouse's plan, if available. Distributions from a spouse's plan pursuant to a QDRO would be exempt from the 10 percent tax, whereas distributions from his or her own IRA made before age 59½ would not be exempt unless another exception, such as the substantially equal periodic payment exception, applies.

If any assets of an individually directed account under a qualified plan are used to purchase collectibles, including works of art, gems, antiques, metals, and certain coins, the amount so used will be treated as distributed from the account.[2]

1. IRC Secs. 402(e)(1); 402(e)(4). See Let. Ruls. 8751040, 8744023.
2. IRC Sec. 408(m).

3842. Is an employee taxed currently on the employer's contributions to a qualified plan?

No, unless the contributions are designated Roth contributions under a 401(k) plan.

A participant does not have to include contributions made by his or her employer in his or her gross income when the participant's rights in the plan become fully vested or when benefits can be paid, if elected by the participant (i.e., if the benefits are constructively received). Rather, there is no taxation until benefits actually are distributed to a participant. Delaying distribution will postpone taxation unless it is delayed too long and minimum distribution requirements are not met (Q 3801 to Q 3813).[1]

Another exception to the general rule on employer contributions not being taxable when contributed is when the plan uses some of those contributions to purchase life insurance on the participant that is payable to a beneficiary of the participant. Basically, the participant reports as income the cost of the pure death benefit under the contract. This cost is determined based on a table referred to as the 2001 table. For the method of determining the "cost" of such insurance protection taxable to the employee, see Q 3843.

Effective January 1, 2015, premiums paid by a pension, profit sharing trust, stock bonus plan, 401(h) plan, pension plan, or annuity plan on accident or health insurance for an employee are currently taxable to the employee as distributions from the trust.[2] Final regulations effective May 12, 2014 clarify that amounts used to pay accident or health insurance premiums (but not disability insurance that replaces contributions) are taxable distributions, with some exceptions, regardless of whether the employer pays the premium from a current year contribution or forfeitures.[3] Thus, if a trustee of a qualified trust uses employer contributions or trust earnings to purchase insurance to provide post-retirement medical benefits in an IRC Section 401(h) account or to pay accident or medical benefits, the amounts applied are not taxable income to the employee for whom the insurance is purchased.[4]

In contrast, a direct distribution from a pension, profit sharing trust, stock bonus plan, 401(h) plan, pension plan, or annuity plan to reimburse an employee for medical expenses is not a taxable distribution to the employee.[5]

Regulations also clarify that with respect to pension, annuity, profit sharing and stock bonus plans, the payment of disability premiums for insurance that replaces retirement contributions are not a distributions.[6]

1. IRC Secs. 402(a), 403(a); Treas. Regs. §§1.402(a)-1(a), 1.403(a)-1.
2. Rev. Rul. 61-164, 1961-2 CB 99, Treas. Reg. §1.402(a)-1(e)(1)(i).
3. 79 FR 26838 (May 12, 2014), amending §1.401(a)-1(e)).
4. Treas. Reg. §1.402(a)-1(e)(iii)(2).
5. Treas. Reg. §1.402(a)-1(e)(1)(ii).
6. Treas. Reg. §1.402(a)-1(e)(1)(iii).

Where a governmental employer "picks up" plan contributions otherwise designated as employee contributions, the contributions are treated as employer contributions.[1] These contributions are excluded from the employee's income and are not subject to withholding.[2] A state law authorizing various retirement systems to "pick up" contributions is not sufficient to effectuate a "pick up" of employee contributions.[3] A governmental employer must specify that contributions designated as employee contributions are being paid by the employer in lieu of employee contributions, and the employee must not have the option of choosing to receive the contribution directly.[4] The required specification of payment of designated employee contributions by the employer must be completed before the period to which the contributions relate; retroactive "pick up" is not permitted.[5] An employer may "pick up" either pre-tax or after-tax contributions used to repurchase service credit.[6]

Contributions to a Plan that has Lost Its Tax Qualification

Contributions to a plan that has ceased to be tax qualified are taxed to an employee in the first year in which his or her right to such amounts is no longer subject to a substantial risk of forfeiture.[7] Thus, an employee is taxed on these contributions to the extent that the employee is vested.

If a plan fails to be tax qualified solely because it does not satisfy either the minimum participation rule (in the case of a defined benefit plan, see Q 3667) or the coverage requirements (Q 3762), then contributions on behalf of non-highly compensated employees will not be includable in their income. Highly compensated employees must include in income their vested accrued benefits (other than their basis in the account).[8]

Social Security Taxes

Payments to, from, or under a qualified retirement plan are specifically excluded from the definition of wages under the Social Security law. Consequently, neither employer contributions to, nor distributions from, a qualified retirement plan are subject to Social Security taxes.[9] This exclusion does not extend to amounts that a regular (i.e., common law) employee elects to contribute under a cash or deferred arrangement under IRC Section 401(k) or 403(b) plan (Q 3705) or to salary reduction contributions made to governmental 457 plans that are "picked up" by an employer. Elective deferrals under a 401(k) plan, including a Roth 401(k) plan, and the amount of salary reductions and "picked up" contributions by a governmental employer are treated as wages subject to Social Security tax.[10]

1. IRC Sec. 414(h)(2).
2. Rev. Rul. 77-462, 1977-2 CB 358; Let. Ruls. 201317025; 201143032.
3. *Foil v. Comm.*, 92 TC 376 (1989), *aff'd*, 920 F.2d 1196 (5th Cir. 1990).
4. Rev. Rul. 81-35, 1981-1 CB 255; Rev. Rul. 81-36, 1981-1 CB 255; Rev. Rul. 2006-43, 2006-35 IRB; Let. Ruls. 201317025; 9441042.
5. Rev. Rul. 87-10, 1987-1 CB 136, modified by Rev. Rul. 2006-43, 2006-35 IRB; *Alderman v. Comm.*, TC Memo 1988-49.
6. Let. Rul. 200035033.
7. IRC Secs. 402(b)(1), 83.
8. IRC Sec. 402(b)(4).
9. IRC Sec. 3121(a)(5).
10. IRC Sec. 3121(v)(1).

3843. What method is used to determine the cost of current life insurance protection provided in a qualified plan and taxed to common law employee participants?

The cost of life insurance protection provided under a qualified pension, annuity, or profit sharing plan must be included in an employee's gross income for the year in which deductible employer contributions or trust income is applied to purchase life insurance protection.[1] This rule applies whether the insurance is provided under group permanent or individual cash value life insurance policies or term insurance, and whether it is provided under a trusteed or non-trusteed plan.[2] According to letter rulings, the rule applies as well to the protection under a life insurance policy on a third party if proceeds are allocable to an employee's account, as can occur with the funding of a buy-sell arrangement.[3]

An employee is taxed currently on the cost of life insurance protection if the proceeds either are (1) payable to the employee's estate or beneficiary, or (2) payable to the plan's trustee, if the plan requires the trustee to pay them to the employee's estate or beneficiary.[4]

On the other hand, an insured is not taxed on the insurance cost if the trustee has the right to retain any part of the death proceeds.[5] Thus, an insured is not taxed on the cost of key person insurance purchased by the trustee as a trust investment. Likewise, participants are not taxed on the cost of a group indemnity policy purchased to indemnify the trust against excessive death benefit payments.[6]

The insured does not avoid tax on the current cost of the insurance protection merely because, under the terms of the plan, his or her interest in the policy may be forfeited before his or her death and the trust may receive the cash surrender value of the contract.[7]

3844. How is the amount of taxable income determined when cash value insurance is provided under a qualified plan?

Only the cost of the pure amount at risk is treated as a currently taxable distribution. This cost, the amount of taxable income, is determined by applying the one year premium term rate at the insured's age to the difference between the face amount of insurance and the cash surrender value at the end of the year.[8] The applicable rate is the rate for the insured's age on his or her birthday nearest the beginning of the policy year, although the insured's age on his or her last birthday probably would be acceptable to IRS, if used consistently.

For many years, P.S. 58 rates were used to calculate the value of the protection.[9] The IRS, however, revoked Revenue Ruling 55-747 for most purposes.[10]

1. IRC Sec. 72(m)(3)(B); Treas. Reg. §1.72-16(b).
2. Treas. Regs. §§1.402(a)-1(a)(3), 1.403(a)-1(d).
3. See Let. Ruls. 8426090, 8108110.
4. Treas. Reg. §1.72-16(b)(1).
5. Treas. Reg. §1.72-16(b)(6).
6. Rev. Rul. 66-138, 1966-1 CB 25.
7. *Funkhouser v. Comm.*, 58 TC 940 (1972).
8. Treas. Regs. §§1.72-16(b), 1.402(a)-1(a)(3); 1.403(a)-1(d).
9. Rev. Rul. 55-747, 1955-2 CB 228, amplified by Rev. Rul. 67-154, 1967-1 CB 11 and Rev. Rul. 78-420, 1978-2 C.B. 67.
10. See Notice 2002-8, 2002-1 CB 398.

The manner in which the value of current life insurance provided under a qualified plan must be determined is not entirely clear. Guidance issued in 2001 and revised in 2002 provided Table 2001, which sets forth premium rates that replaced the earlier P.S. 58 Table.[1] This table is reproduced in Appendix G. Table 2001 will be used until additional guidance, which was authorized by final regulations in 2003, is published in the Internal Revenue Bulletin.[2]

Until future guidance takes effect, taxpayers may be permitted to use the insurer's lower published premium rates that are available to all standard risks for initial issue one-year term insurance.[3] The IRS does not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless (1) the insurer generally makes the availability of these rates known to persons who apply for term insurance coverage from the insurer, and (2) the insurer regularly sells term insurance at these rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels.[4]

Earlier guidance stated that if an insurer published rates for individual, initial issue, and one-year term policies available to all standard risks, and these rates were lower than the then-applicable P.S. 58 (now Table 2001) rates, these insurer rates could be substituted to the extent provided by Revenue Ruling 66-110.[5] The ability to use the insurer's lower published rates was limited to arrangements entered into before the effective date of the final regulations (i.e., generally, September 17, 2003).[6]

If a profit sharing plan permits a participant to direct a trustee to purchase term insurance riders on either the participant's spouse or dependent children, the cost of the rider must be measured using the P.S. 58 rates (currently Table 2001), not the actual cost of the rider.[7]

The premium paid during an employee's taxable year may cover a period extending into the following year. An employee will not be permitted to apportion the cost between the two years; the employee must include the entire P.S. 58 (currently Table 2001) cost in his or her gross income for the taxable year during which the premium is paid.

If only a portion of the premium is paid during the taxable year, the cost may be apportioned for that year.[8]

An employee who leaves before the end of the year for which a premium has been paid must include in gross income the annual term cost reduced by the unearned premium credit reallocated to pay premiums for remaining employee-participants.[9]

1. See Notice 2002-8, 2002-1 CB 398.
2. See Treas. Reg. §1.61-22(d)(3).
3. See Notice 2002-8, 2002-1 CB 398.
4. See Notice 2002-8, 2002-1 CB 398.
5. 1966-1 CB 12, as amplified by Rev. Rul. 67-154, 1967-1 CB 11 and Rev. Rul. 78-420, 1978-2 C.B. 67.
6. See Notice 2002-8, 2002-1 CB 398; *Neff v. Commissioner*, TC Memo 2012-244.
7. See Let. Rul. 9023044.
8. See Special Ruling, 1946, Pension Plan Guide (CCH), Pre-1986 IRS Tax Releases, ¶17,303.
9. Rev. Rul. 69-490, 1969-2 CB 11.

3845. How is the amount of taxable income determined when term insurance is provided under a qualified plan?

Where individual or group term life insurance is provided under a qualified plan, the cost of the entire amount of protection is taxable to employees. No part of the coverage of group term insurance is exempt under IRC Section 79 (Q 229).[1] Moreover, the cost of the insurance protection cannot be determined by use of the special group term rates that are applicable to taxing excess group term life insurance purchased directly by an employer.[2] It is not settled whether the taxable amount is the actual premium or the P.S. 58 (currently Table 2001) cost.

3846. How is the amount of taxable income determined when life insurance protection is purchased under a contributory plan?

Life insurance protection purchased under a contributory plan is considered to have been paid first from employer contributions and trust earnings, unless the plan provides otherwise. Thus, the P.S. 58 (currently Table 2001) costs are taxed to the employee unless the plan provides that employee contributions are to be applied to the insurance cost.[3]

If amounts attributable to deductible employee contributions, including net earnings allocable to them, are used to purchase life insurance, the amount used, not the P.S. 58 (currently Table 2001) cost, is included in the employee's gross income.[4] It is unclear whether such amounts are subject to a premature distribution penalty; the IRS has specifically exempted P.S. 58 (currently Table 2001) costs of life insurance protection included in income from such a penalty (Q 3860). Although the deduction for any contribution used to purchase life insurance is not disallowed, it is, in effect, offset. Loans under the policy would be considered a distribution, including automatic premium loans on default of payment of a premium.

3847. May the cost of life insurance protection provided under a qualified plan be recovered tax-free when benefits are paid?

If life insurance protection under a plan is provided by a cash value policy and the employee has reported the pure death benefit each year, then the total amount reported will be the basis in the contract under Table 2001 (formerly P.S. 58) (Q 3843). That basis may be recovered tax-free if it is paid as a death benefit directly to the beneficiary of the participant.

If a contract is distributed to a participant as a benefit, then the basis in that contract is not taxable.[5] It does not matter whether the contract is distributed or is cashed in and that amount is distributed. It would seem that deductible employee contributions that have been applied to purchase life insurance and taxed to the employee also would be recovered tax-free from benefits

1. IRC Sec. 79(b)(3).
2. Treas. Regs. §§1.79-1(a)(3), 1.79-3(d)(3).
3. Rev. Rul. 68-390, 1968-2 CB 175.
4. IRC Sec. 72(o)(3).
5. Treas. Reg. §1.72-16(b).

received under the policy.[1] The amount recoverable is the total amount of income that has been reported, and not just the taxes paid on that income.[2]

Regulations say that "each separate program of the employer consisting of interrelated contributions and benefits" is a single contract. Where retirement benefits and life insurance are separately provided (e.g., through retirement income contracts and a side fund), they generally are separate programs. Thus, if insurance is provided under a separate term policy, the taxable cost cannot be recovered from the retirement benefits.[3]

Where a plan was amended to eliminate death benefits for employees dying prior to age sixty-five and its trustees redeemed the whole life insurance policies and invested the proceeds in various securities, the plan became a single program of interrelated contributions and benefits; the employees then could recover their taxable insurance cost from distributions from the plan.[4]

Where, under a combination plan, the trustee surrendered the life insurance policy and used both the policy's cash surrender value and the auxiliary fund to purchase an immediate annuity for a retiring employee, the employee could not recover the taxable insurance costs from the annuity payments; the result would have been different had the auxiliary fund been applied to a settlement under the life insurance policy.[5]

Similarly, where life insurance policies were surrendered and the value used to provide a cash lump sum distribution, the costs taxed to the employee under Table 2001 or P.S. 58 (Q 3843) were not part of the employee's cost recoverable from the distribution. Thus, they could be included in the amount rolled over (Q 3883).[6]

Where nondeductible employee contributions have been earmarked under plan provisions for payment of the cost of life insurance protection, a letter ruling provided the following guidelines: (1) if the life insurance contracts are surrendered by the trustee and payment is made as a lump sum distribution or otherwise, the employee's basis is the amount of the employee's nondeductible contributions to the plan that were not applied to the cost of life insurance protection, and (2) if the life insurance contract is distributed as part of the distribution, the employee's basis is (x) the amount of the employee's nondeductible contributions to the plan, including those applied to the cost of life insurance protection, plus (y) any additional amounts taxed to the employee as the cost of life insurance protection under Table 2001 or P.S. 58 (Q 3848).[7] For estate tax results, see Q 3877.

Keogh Plans

A self-employed individual does not include any costs the individual paid for life insurance protection under Table 2001 or P.S. 58 (Q 3843) in the individual's cost basis of benefits

1. See IRC Sec. 72(o)(3)(B).
2. Treas. Reg. §1.72-16(b)(4). See Let. Rul. 8539066.
3. Treas. Reg. §1.72-2(a)(3), Ex. 6.
4. Let. Rul. 8721083.
5. Rev. Rul. 67-336, 1967-2 CB 66.
6. Let. Ruls. 7902083, 7830082.
7. Let. Rul. 7922109.

received under the contract.[1] Rather, a self-employed individual loses the tax deduction for the part of the employer's contribution that is allocable to the cost of pure insurance protection for himself or herself.

In other words, the income tax deduction must be based on the balance of the premium after subtracting the one year term cost of the current life insurance protection.[2]

The premium attributable to a waiver of premium provision may not be deducted.[3] If any trust earnings are applied to purchase life insurance protection under a trusteed plan, however, a self-employed individual must include the cost, determined under Table 2001 or P.S. 58 (Q 3843) in gross income.[4] The life insurance cost is determined in the same manner as for regular employees under Table 2001 or P.S. 58 (Q 3843). The cost of life insurance protection included in income may not be included in an owner-employee's cost basis.[5]

3848. What are the tax and qualification consequences of a loan from a qualified plan?

Qualified plans may permit participants to borrow from their accounts, but are not required to permit loans. A loan from a plan to a participant or to a beneficiary will be treated as a taxable distribution unless it meets certain requirements regarding:

(1) the enforceability of the agreement,

(2) the term of the loan,

(3) repayment, and

(4) a limitation on the maximum loan that may be made (Q 3849).[6]

In certain situations, a violation of one of these requirements will not result in taxation to the participant if the violation is corrected under EPCRS.

Repayment of a loan treated as a distribution will be considered a nondeductible employee contribution for tax purposes.[7] When a recipient's benefit is later distributed to the recipient, the amount already taxed will not be taxed again. Repayments constitute investment in the contract (i.e., basis)[8] and are not considered annual additions subject to the IRC Section 415 limits.[9]

1. Treas. Reg. §1.72-16(b)(4).
2. IRC Sec. 404(e); Treas. Reg. §1.404(e)-1(b)(1).
3. Treas. Reg. §1.404(e)-1(b)(1).
4. IRC Sec. 72(m)(3)(B); Treas. Reg. §1.72-16(b)(2).
5. Treas. Reg. §1.72-16(b)(4).
6. IRC Sec. 72(p)(2); Treas. Reg. §1.72(p)-1, A-3.
7. Sen. Rept. 97-494, 97th Cong. 2nd Sess.
8. Let. Rul. 9122059.
9. Notice 82-22, 1982-2 CB 751.

Plan Qualification

A qualified plan generally can provide for loans to participants if they are adequately secured, bear a reasonable rate of interest, have a reasonable repayment schedule, and are made available on a nondiscriminatory basis.[1] If a plan is subject to automatic survivor benefit requirements, the loan may require spousal consent (Q 3792).

Treatment of a loan as a distribution for tax purposes generally does not affect the plan's tax qualification. A bona fide loan that is not a prohibited transaction (Q 3871) will not cause a pension plan to fail to satisfy the requirement that a pension plan primarily provide benefits for employees or their beneficiaries over a period of years or for life after retirement.[2] When a plan loaned out almost all of its assets to the company president, without seeking adequate security, a fair return, or prompt repayment, the plan was held not to have been operated for the exclusive benefit of the employees and plan disqualification was justified.[3]

A deemed distribution under IRC Section 72(p) will not be treated as an actual distribution for purposes of the qualification requirements of IRC Section 401; thus, plan qualification will not be affected by reason of a deemed distribution. If a participant's accrued benefit is reduced or offset to repay a plan loan, an actual distribution occurs for purposes of IRC Section 401. This occurs generally when a participant with a loan terminates employment with the employer, if so specified in the loan agreement. An offset distribution from a 401(k) plan or a pension plan at a time when the plan is not otherwise permitted to make a distribution would result in plan disqualification.[4]

A plan loan that is secured by a participant's or a beneficiary's interest in the plan but that is not a prohibited transaction generally will not be an assignment or alienation of plan benefits that would disqualify a plan.[5] If there is a tacit understanding that collection of a loan is not intended, however, the loan may be treated as a disqualifying distribution if made at a time when the plan is not permitted to make distributions.[6]

When an actual distribution follows a deemed distribution, a plan must treat the loan transition amount as an outstanding loan that is taxable on actual distribution. The loan transition amount is the amount by which the initial default amount, attributed as tax basis, exceeds the tax basis immediately preceding the transition date, plus any increase in tax basis thereafter. The plan may not attribute investment in the contract as a loan repayment (Q 3864). The tax basis in the distribution is determined based on the initial default amount and, to the extent that a tax basis has been attributed, it must be reduced by the initial default amount.

1. IRC Sec. 4975(d)(1); Notice 82-22, 1982-2 CB 751; Rev. Rul. 71-437, 1971-2 CB 185; Rev. Rul. 67-288, 1967-2 CB 151.
2. Notice 82-22, 1982-2 CB 751.
3. *Winger's Dept. Store, Inc. v. Comm.*, 82 TC 869 (1984).
4. See Treas. Reg. §1.72(p)-1, A-12, A-13.
5. Treas. Reg. §1.401(a)-13(d)(2). See Q 3815. See also Notice 82-22, 1982-2 CB 751.
6. See Rev. Rul. 71-437, 1971-2 CB 185.

Cash repayments made after a loan is deemed to have been distributed will increase the participant's tax basis as if they were after-tax contributions, although they are not treated as after-tax contributions for other purposes.[1]

Prohibited transactions. Plan loans that do not meet any of the requirements for a prohibited transaction exemption (Q 3871) could result in excise taxes and possible plan disqualification. The prohibited transaction rules apply to a loan that does not meet the exemption requirements, even if it is treated as (and taxed as) a distribution (Q 3871). Loans from a qualified plan to certain S corporation shareholders, partners, and sole proprietors also may qualify for the prohibited transaction exemption (Q 3871).[2]

Investments in residential mortgages. Plan investments in residential mortgages of employees, other than officers, directors, or owners, or their beneficiaries, are permitted but are subject to limitations of IRC Section 72(p) unless they are made in the ordinary course of a plan investment program that is not limited to participants and their beneficiaries.[3] A longer term may be permitted (Q 3849).

Mandatory Withholding

Distributions that constitute eligible rollover distributions from a qualified plan generally are subject to mandatory income tax withholding at the rate of 20 percent, unless the participant elects a direct rollover.[4] The IRS has stated that a deemed distribution attributable to a plan loan that does not meet the requirements of IRC Section 72(p) will not be subject to the 20 percent mandatory withholding requirement because such a distribution cannot be an eligible rollover distribution.

Where a participant's accrued benefit is reduced or offset to repay a plan loan, such as when employment is terminated, the offset amount may constitute an eligible rollover distribution.[5] Mandatory withholding is required on a deemed distribution of a loan, or a loan repayment by benefit offset, to the extent that a transfer included cash or property other than employer securities at the same time.[6]

3849. What requirements must a qualified plan loan meet to avoid taxation as a distribution?

To avoid being taxed as a distribution, a loan made from a plan to a participant or beneficiary must be made pursuant to an enforceable agreement that meets certain requirements with respect to the term of the loan (Q 3851), its repayment (Q 3852), and the dollar amount loaned (Q 3853).[7]

1. Treas. Reg. §1.72(p)-1, A-19 through A-21. See also Treas. Reg. §1.72(p)-1, A-1 through A-18.
2. IRC Sec. 4975(f)(6)(B)(iii).
3. Treas. Reg. §1.72(p)-1, A-18.
4. IRC Sec. 3405(c).
5. See Notice 93-3, 1993-1 CB 293.
6. Treas. Reg. §1.72(p)-1, A-15.
7. IRC Sec. 72(p)(2); Treas. Reg. §1.72(p)-1, A-3(a).

3850. Must a qualified plan loan be evidenced by a loan agreement to avoid taxation as a distribution?

A plan loan must be evidenced by a legally enforceable agreement, which may consist of more than one document. The agreement must specify the date, amount, and term of the loan, as well as the repayment schedule. The agreement need not be signed if it is enforceable without a signature under applicable law.[1] The date of the loan is the date the loan is funded (i.e., the date of delivery of the check to the participant).[2]

An agreement must be set forth in a written paper document, an electronic medium, or any other form approved by the IRS.[3] If a loan agreement is in the form of an electronic medium, the medium must be reasonably accessible to the participant or beneficiary and must be provided under a system that is reasonably designed to preclude any individual other than the participant or beneficiary from requesting a loan.[4]

The system also must provide the participant or beneficiary with a reasonable opportunity to review the terms of the loan, and to confirm, modify, or rescind the terms of the loan before it is made.[5] Finally, the system must provide a confirmation to the participant or beneficiary within a reasonable time after the loan is made. The confirmation may be made on a written paper document or through an electronic medium that meets the accessibility requirements above. The electronic confirmation must be no less understandable than a written paper document and must inform the participant or beneficiary of his or her right to receive confirmation via a written paper document at no charge.[6]

3851. How long can a qualified plan loan remain outstanding in order to avoid being taxed as a distribution?

The term of a loan must be no longer than five years. If a loan does not meet the term requirement, the entire loan is a distribution.[7] A distribution is deemed to occur the first time the term requirement is not met in form or operation; thus, it may occur at the time the loan is made, or at a later date.[8]

If a loan initially satisfies the term requirement but payments are not made under the terms of the loan, a deemed distribution occurs as a result of the failure to make the payments.[9] Although such a failure will constitute an immediate violation of the loan provisions, the plan may allow for a cure period of up to three months beyond the calendar quarter in which the payment was due. A distribution in the amount of the entire outstanding balance of the loan will be deemed to have occurred on the last day of the cure period.[10] Legislative history suggests

1. Treas. Reg. §1.72(p)-1, A-3(b).
2. ABA Joint Committee on Employee Benefits, Meeting with IRS and Department of Treasury Officials, May 7, 2004 (Q&A-4).
3. Treas. Reg. §1.72(p)-1, A-3(b).
4. Treas. Reg. §1.72(p)-1, A-3(b)(2).
5. Treas. Reg. §1.72(p)-1, A-3(b)(2)(ii).
6. Treas. Reg. §1.72(p)-1, A-3(b)(2)(iii).
7. IRC Sec. 72(p)(2)(b)(i).
8. Treas. Reg. §1.72(p)-1, A-4.
9. Treas. Reg. §1.72(p)-1, A-4.
10. Treas. Reg. §1.72(p)-1, A-10.

that a loan treated as a distribution because its repayment period was not limited to five years cannot be corrected by renegotiation or repayment.[1] If a loan is outstanding when a total distribution is made to a participant, the loan is treated as repaid (and the amount included in the distribution) on the date of distribution; thus, inclusion in income cannot be deferred until the end of the five year period.[2]

An exception to the five year rule exists for residence loans used to acquire a dwelling unit that is to be, within a reasonable time, the principal residence of the participant (Q 3854).[3]

3852. What repayment requirements must apply to qualified plan loans?

The loan agreement must specify the amount and term of the loan and the repayment schedule.[4] Failure to make a timely payment of a plan loan installment when due generally will result in a deemed distribution, but the agreement may provide for a cure period so long as the cure period does not extend beyond the end of the calendar quarter following the quarter in which the payment was due.[5]

A loan that was not repayable in full within five years and that had a balloon payment at the end was held to be a premature distribution subject to the 10 percent penalty (Q 3860) because it violated both the term requirement and the level amortization requirement. The participant was not subject to the substantial understatement or negligence components of the accuracy-related penalty because the participant relied in good faith on the plan administrator's representations that the plan loan was in compliance.[6]

It should be noted that U.S. bankruptcy courts have held that a debtor's repayment of a participant loan from a 401(k) plan is not necessary for support and thus is not exempt from the bankruptcy estate (Q 3815).[7]

Repayment During Military Service

A participant may suspend repayment of a loan during any period that he or she serves in the military.[8] This rule applies regardless of whether the service performed is "qualified military service" under the Uniformed Services Employment and Reemployment Rights Act of 1994. The suspension of repayment under these circumstances may extend beyond one year, unlike the suspension rules for other leaves of absence.[9]

A participant must resume loan repayment once the participant completes his or her service with the uniformed services, at which time payments must be made as frequently and in an amount no less than was made before the suspension. The latest permissible term of the loan

1. Sen. Rept. 97-760, 97th Cong. 2nd Sess.
2. Let. Rul. 8433065.
3. IRC Sec. 72(p)(2)(B)(ii).
4. Treas. Reg. §1.72(p)-1, A-3(b).
5. Treas. Reg. §1.72(p)-1, A-10.
6. *Plotkin v. Comm.*, TC Memo 2001-71.
7. *In re Darcy I. Estes*, 254 BR 261 (2000), *In re Cohen*, 246 BR 658 (2000).
8. IRC Sec. 414(u)(4).
9. Treas. Reg. §1.72(p)-1, A-9.

is five years from the date of the original loan, plus any period during which repayment was suspended due to military service.[1]

3853. Are there limits on the amount that can be borrowed under a qualified plan loan?

The amount of the loan, when added to the outstanding balance of all other loans, whenever made, from all plans of the employer, may not exceed the lesser of (1) $50,000 (reduced by the excess of the highest outstanding balance of plan loans during the one-year period ending on the day before the date when the loan is made over the outstanding balance of plan loans on the date when the loan is made), or (2) one-half of the present value of the employee's non-forfeitable accrued benefit under the plans, determined without regard to any accumulated deductible employee contributions. A plan may provide that a minimum loan amount of up to $10,000 may be borrowed, even if it is more than one-half of the present value of the employee's non-forfeitable accrued benefit.[2] For valuation purposes, a valuation within the prior twelve months may be used, if it is the latest available.[3]

If a loan does not meet the dollar limitation, distribution of the amount in excess of the dollar limit is deemed to occur when the loan is made.[4] If the outstanding loan balance meets the dollar limitation immediately after the date when the loan is made, the loan will not be treated as a distribution merely because the present value of the employee's non-forfeitable accrued benefit subsequently decreases.[5]

In determining the outstanding balance and the present value of the non-forfeitable accrued benefit under a plan, an employer's plans include plans of all members of a controlled group of employers, of trades and businesses under common control, and of members of an affiliated service group (Q 3830, Q 3832).[6] The plans include all qualified pension, profit sharing, and stock bonus plans, all Section 403(b) tax sheltered annuities, and all Section 457 deferred compensation plans of aggregated employers.[7]

3854. What other rules apply to loans from a qualified plan?

Residence Loans

Plan investments in residential mortgages, other than to officers, directors, owners, or their beneficiaries, are permitted, subject to the limitations of IRC Section 72(p) (Q 3849) unless they are made in the ordinary course of a plan investment program that is not limited to participants and their beneficiaries.[8]

1. Treas. Reg. §1.72(p)-1, A-9.
2. IRC Sec. 72(p)(2)(A).
3. Notice 82-22, 1982-2 CB 751.
4. Treas. Reg. §1.72(p)-1, A-4(a).
5. General Explanation—TEFRA, p. 296.
6. IRC Sec. 72(p)(2)(D)(i).
7. IRC Sec. 72(p)(2)(D)(ii).
8. Treas. Reg. §1.72(p)-1, A-18.

Provided a loan is to acquire a dwelling unit that is to be, within a reasonable time, the principal residence of the participant, it will not be subject to the term requirement (Q 3849).[1] The determination of whether the unit is to be used, within a reasonable time, as the participant's principal residence is made when the loan is made. Legislative history indicates that a dwelling unit includes a house, apartment, condominium, or mobile home not used on a transient basis. The determination of whether plan loan proceeds are used for the purchase or improvement of a principal residence is made using the tracing rules under IRC Section 163(h)(3)(B).[2]

Planning Point: Although a mortgage is not required for this purpose,[3] a participant may want to give the trustee a mortgage to qualify the interest as deductible interest. Treasury Department regulations require that for interest to be deductible as qualified residence interest the borrower must give the lender a mortgage and the lender actually must take the step of recording the mortgage. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

No specific time limit is placed on residential loans, but the loans must provide for substantially level amortization, with payments to be made at least quarterly.[4] This requirement does not preclude repayment or acceleration of the loan prior to the loan period, or the use of a variable interest rate.[5] All loans, regardless of when made, must provide for a reasonable repayment schedule to qualify as a loan exempt from the prohibited transaction rules (Q 3871). A loan need not be secured by the residence to be considered a principal residence plan loan.[6]

Assuming that a loan is otherwise a bona fide debt, a taxpayer may deduct interest paid on a mortgage loan from his or her qualified plan, even though the amount by which the loan exceeded the $50,000 limit of IRC Section 72(p) was deemed to be a taxable distribution.[7]

Plan Loans

Both direct and indirect loans are considered loans. A participant's or beneficiary's assignment, agreement to assign, pledge, or agreement to pledge any portion of his or her interest in the plan is considered to be a loan of that portion. If a participant's interest in a plan is pledged or assigned as security for a loan, only the amount of the loan, not the amount assigned or pledged, is treated as a loan.[8]

Any amount received as a loan under a contract purchased under a plan, and any assignment or pledge with respect to such a contract, is treated as a loan under the plan.[9] This would appear to treat a policy loan by a trustee as a loan to the participant. If a premium that is otherwise in default is paid in the form of a loan against the contract, the loan is not considered made to the participant unless the contract has been distributed to the participant.[10]

1. See IRC Sec. 72(p)(2)(B)(ii).
2. Treas. Reg. §1.72(p)-1, A-7.
3. See Treas. Reg. §1.72(p)-1, A-6.
4. See IRC Sec. 72(p)(2)(C).
5. General Explanation — TRA '86, p. 728.
6. Treas. Reg. §1.72(p)-1, A-6.
7. FSA 200047022.
8. Treas. Reg. §1.72(p)-1, A-1.
9. IRC Secs. 72(p)(1)(B), 72(p)(3).
10. General Explanation – TEFRA, p. 295.

The IRS has stated, in a general information letter, that where plan participants received mortgage loans from a bank that were contingent on the plan making deposits equal to the loan amounts, the loans were indirect plan loans for purposes of IRC Section 72(p).[1]

A loan received by a beneficiary is treated as received by the participant if he or she is alive at the time the loan is treated as a distribution.[2]

3855. How do renegotiations, extensions, renewals, or revisions work in the context of qualified plan loans?

Any loan balance outstanding on August 13, 1982 (September 3, 1982, in the case of certain government plans) that is renegotiated, extended, renewed, or revised is treated as a loan made on the date it is renegotiated, extended, renewed, or revised.[3]

A consolidation of two qualified plans is not a renegotiation, extension, renewal, or revision that would subject a loan to the provisions of IRC Section 72(p).[4]

Similarly, the transfer of a participant's account balance, including an outstanding loan, in a trustee-to-trustee transfer is not treated as such a renegotiation, extension, renewal, or revision.[5]

A plan loan offset against the participant's account balance when the plan terminated was treated as a constructive distribution, subject to income tax and penalties.[6]

3856. How does the interest deduction apply to qualified plan loans?

An employee is not allowed an interest deduction with respect to a loan (otherwise meeting the requirements explained in (Q 3849) made after 1986 during the period on or after the first day on which the borrower is a key employee (Q 3828) or in which the loan is secured by elective contributions made to a 401(k) plan or tax sheltered annuity.[7] Loans from a qualified retirement plan do not qualify as a qualified education loan for which an interest deduction is available.[8]

3857. How do refinancing transactions work in the context of qualified plan loans?

A refinancing transaction is any transaction in which one loan replaces another. For example, a refinancing may exist if the outstanding loan amount is increased or if the interest rate or the repayment term of the loan is renegotiated.[9]

1. See IRS General Information Letter, 5 Pens. Pl. Guide (CCH) ¶17,383J (August 12, 1992).
2. General Explanation – TEFRA, p. 295.
3. TRA '86, Sec. 1134(e). See e.g., TAM 9344001.
4. Let. Rul. 8542081.
5. Let. Rul. 8950008.
6. *Caton v. Comm.*, TC Memo 1995-80.
7. IRC Sec. 72(p)(3).
8. Treas. Reg. §1.221-1(f)(3).
9. Treas. Reg. §1.72(p)-1, A-20(a).

If the term of a replacement loan ends later than the term of the loan it replaces, then both loans are treated as outstanding on the date of the refinancing transaction. This generally means that the loans must collectively satisfy the requirements of IRC Section 72(p).[1] There is an exception where the replacement loan would satisfy IRC Section 72(p)(2) if it were treated as two separate loans. Under this exception, the amount of the replaced loan, amortized over a period ending no later than the end of the original term of the replaced loan or five years, if later, is treated as one loan. The other loan is for an amount equal to the difference between the amount of the replacement loan and the outstanding balance of the replaced loan.[2]

The IRS will not view the transaction as circumventing IRC Section 72(p) if a replacement loan effectively amortizes an amount equal to the replaced loan within the original term of the replaced loan or within five years, if later. For this reason, the outstanding balance of a replaced loan need not be taken into account in determining whether the limitations of IRC Section 72(p)(2) have been met; only the amount of the replacement loan plus any existing loans that are not being replaced is considered.[3] If the term of a replacement loan does not end later than the term of the replaced loan, then only the amount of the replacement loan plus the outstanding balance of any existing loans that are not being replaced must be taken into account in determining whether IRC Section 72(p) has been satisfied.[4]

Multiple Loans

Where a participant receives multiple loans from a qualified retirement plan, each loan must separately satisfy IRC Section 72(p), taking into account the outstanding balance of each existing loan. The refinancing rules do not apply because the new loan is not used to replace any existing loan.[5] Earlier proposed regulations set a limit of two loans per participant within a single year, but final regulations contain no such limit.[6]

3858. Are deemed distributions treated as outstanding loans?

For purposes of the dollar limitation on loans under IRC Section 72(p) (Q 3849), a loan treated as a deemed distribution is considered an outstanding loan until it is repaid.[7]

Regulations place two conditions on loans made while a deemed distribution loan remains unpaid.

First, the subsequent loan must be repayable under a payroll withholding arrangement enforceable under applicable law. The arrangement may be revocable, but should the participant revoke it, the outstanding loan balance is treated as a deemed distribution.

Second, the participant must provide the plan with adequate collateral for the loan in addition to the participant's accrued benefit. If, for any reason, the additional collateral ceases to be

1. Treas. Reg. §1.72(p)-1, A-20(a)(2).
2. Treas. Reg. §1.72(p)-1, A-20(a)(2).
3. Treas. Reg. §1.72(p)-1, A-20(a)(2).
4. Treas. Reg. §1.72(p)-1, A-20(a)(1).
5. Treas. Reg. §1.72(p)-1, A-20(a)(1).
6. Treas. Reg. §1.72(p)-1, A-20(a)(2).
7. Treas. Reg. §1.72(p)-1, A-19.

in force before the subsequent loan is repaid, the outstanding balance of the subsequent loan is treated as a deemed distribution.

If these conditions are not satisfied, the entire subsequent loan is treated as a deemed distribution under IRC Section 72(p).[1]

3859. How is an employee taxed on preretirement distributions from a qualified plan?

Preretirement distributions, meaning those received before the annuity starting date, that are made to an employee from a qualified plan are fully included in gross income except to the extent allocated to investment in the contract, as described below.[2] Early or premature distributions generally are subject to an additional tax (Q 3860).

A participant who has an investment or cost basis (Q 3864) in a contract under a pension, profit sharing, or stock bonus plan, or under an annuity contract purchased by any such plan, is taxed under a rule that provides for pro rata recovery of cost.[3] The employee excludes the portion of the distribution that bears the same ratio to the total distribution as his or her investment in the contract bears to the total value of the employee's accrued benefit on the date of the distribution.

The total value of an employee's account balance generally is the fair market value of the total assets under the account, excluding any net unrealized appreciation attributable to employee contributions, whether or not all of such securities are distributed.[4] The annuity starting date is the first day of the first period for which an amount is received as an annuity under the plan or contract (Q 460).[5]

Employee contributions under a defined contribution plan may be treated as a separate contract for purposes of these rules.[6] A defined benefit plan is treated as a defined contribution plan to the extent that employee contributions and earnings thereon are credited to a separate account to which actual earnings and losses are allocated.[7]

Conversely, the IRS privately ruled that there was a single contract in the case of a defined benefit plan that did not credit earnings on employee after-tax contributions and allowed single sum withdrawal of such contributions at retirement, in exchange for actuarially reduced lifetime pension payments. The withdrawn amounts were taxed as preretirement distributions under IRC Section 72(e)(8)(B) and the investment in the contract with respect to the remaining benefit was reduced by the amount of such distribution.[8]

1. Treas. Reg. §1.72(p)-1, A-19.
2. IRC Secs. 72(e)(8), 72(e)(2)(B).
3. See IRC Sec. 72(e)(8).
4. Notice 87-13, 1987-1 CB 432, A-11, as modified by Notices 98-483, 1998-2 CB 365 and 2000-30, 2000-1 CB 1266; Rev. Rul. 2002-62, 2002-2 CB 710.
5. IRC Sec. 72(c)(4).
6. IRC Sec. 72(d)(2).
7. IRC Sec. 414(k)(2); Notice 87-13, 1987-1 CB 432, A-14. See also, Let. Ruls. 9618028, 8916081.
8. Let. Rul. 9847032.

A lump sum distribution received under the alternative form of the Civil Service Retirement System annuity did not qualify as a defined contribution plan or a hybrid plan under these rules; thus it was not subject to separate contract treatment.[1]

Grandfather Rule

If, on May 5, 1986, a plan permitted in-service withdrawal of employee contributions, the pro rata recovery rules do not apply to investment in the contract prior to 1987. Instead, investment in the contract prior to 1987 will be recovered first, and the pro rata recovery rules will apply only to the extent that amounts received before the annuity starting date, when added to all other amounts previously received under the contract after 1986, exceed the employee's investment in the contract as of December 31, 1986.[2] If employee contributions are transferred after May 5, 1986 from a plan that permitted in-service withdrawals to another plan permitting such withdrawals, the pre-1987 investment in the contract under both plans continues to qualify for this grandfather treatment. If the transferor plan did not permit such in-service withdrawals, only the pre-1987 investment in the contract under the transferee plan qualifies.[3]

An employee who cashed out prior to 1986 and buys back after 1986 cannot use the grandfather rule because there is no pre-1987 investment in the contract. Even if the cash-out occurs after 1986 and there was investment in the contract as of December 31, 1986, the cash-out causes a permanent reduction in the grandfathered investment that may not be restored by a later buy-back.[4]

Where an employer amended its plan to provide that employees could receive distributions at their request, but not less than the minimum amounts that must be distributed by the applicable distribution date under IRC Section 401(a)(9), distributions were not annuity payments and there was no annuity starting date, so distributions were treated as amounts received before the annuity starting date and were subject to grandfather rule of IRC Section 72(e)(8)(D).[5]

Where a state's defined benefit plan allowed eligible participants to elect optional retirement with partial lump sum distributions ("PLSDs") and PLSDs were received within the window of eligibility specified in TAMRA '88, Section 1011A(b)(11), the PLSDs were taxable, on a pro-rata basis under IRC Section 72(e) to the extent that they exceeded the recipient's investment in the plan.[6]

3860. What is an early distribution from a qualified plan, and what penalties relate to it?

Except as noted below, amounts distributed from qualified retirement plans before the participant reaches age 59½ are early or premature distributions subject to an additional tax equal to 10 percent of the amount of the distribution includable in gross income.[7]

1. *George v. U.S.*, 96-2 USTC ¶50,389 (Fed. Cir. 1996); *Logsdon v. Comm.*, TC Memo 1997-8.
2. IRC Sec. 72(e)(8)(D); see also Let. Ruls. 9652031, 8747061.
3. Notice 87-13, 1987-1 CB 432, A-13. See also, Let. Ruls. 8829017, 8829006.
4. Notice 89-25, 1989-1 CB 662, A-5, modified by Notice 2002-62.
5. Let. Ruls. 200117044, 200117045.
6. Let. Rul. 200114040.
7. IRC Sec. 72(t).

To the extent that they are attributable to rollovers from a qualified retirement plan or a Section 403(b) plan, amounts distributed from Section 457 plans (Q 3568) generally will be treated as distributed from a qualified plan, for purposes of the early distribution penalty.[1]

The 10 percent penalty tax does not apply to distributions:

(1) made to a beneficiary, or the employee's estate, on or after the death of the employee;

(2) attributable to the employee's disability;[2]

(3) that are part of a series of substantially equal periodic payments made at least annually for the life or life expectancy of the employee or the joint lives or joint life expectancies of the employee and his or her designated beneficiary, and beginning after the employee separates from the service of the employer (Q 3631);

(4) made to an employee after separation from service during or after the year in which the employee attained age fifty-five, or age fifty for distributions to qualified public safety employees from a governmental plan as defined in IRC Section 414(d) that is a defined benefit plan, or made to certain employees who had separated from service as of March 1, 1986;[3]

(5) made to an alternate payee under a qualified domestic relations order (Q 3816);

(6) made to an employee for medical care, but not in excess of the amount allowable as a deduction to the employee under IRC Section 213 for amounts paid during the year for medical care, determined without regard to whether the employee itemizes deductions for the year;

(7) made to reduce an excess contribution under a 401(k) plan (Q 3733);

(8) made to reduce an excess employee or matching employer contribution, that is, an excess aggregate contribution (Q 3733);[4]

(9) made to reduce an excess elective deferral (Q 3705);[5]

(10) that are dividends paid with respect to stock of a corporation described in IRC Section 404(k) (Q 3746);

(11) made on account of certain levies against a qualified plan;[6] or

(12) that are qualified reservist distributions, which are distributions of elective deferrals made to reserve members of the U.S. military called to active duty for 180 days or

1. IRC Sec. 72(t)(9).
2. As defined in IRC Section 72(m)(7).
3. IRC Sec. 72(t)(10); TRA '86, Sec. 1123(e)(3).
4. See IRC Sec. 401(m)(7).
5. IRC Sec. 402(g)(2)(C).
6. Under IRC Sec. 6331.

more at any time after September 11, 2001. Reservists have the right to rollover the amount of any distributions to an individual retirement plan for two years following the end of active duty.[1]

The IRS has approved three methods for determining what constitutes a series of substantially equal periodic payments in the exception discussed in (3) above. If the series of payments is later modified, other than because of death or disability, before the employee reaches age 59½, or if after the employee reaches age 59½, within five years of the date of the first payment, the employee's tax for the year in which the modification occurs is increased by an amount equal to the tax that would have been imposed in the absence of the exception, plus interest for the deferral period. For an explanation of the calculation under each method, the definition of "modified," and related rulings, see Q 3631.

The exception for distributions pursuant to a QDRO (see (5) above) was not applicable where a participant took a distribution from the plan following a trade of other marital property rights for his or her spouse's waiver of rights in his or her plan benefits.[2]

A court determined that a distribution originating from an arbitration award was subject to the 10 percent penalty because the amounts attributable to the award were thoroughly integrated with benefits provided under the state retirement plan.[3] The involuntary nature of a distribution does not preclude the application of the tax, provided that the participant had an opportunity, such as by a rollover, to avoid the tax.[4]

The IRS has stated that the garnishment of an individual's plan interest under the Federal Debt Collections Procedure Act to pay a judgment for restitution or fines as discussed in (11) above, will not trigger the application of the 10 percent penalty.[5]

Planning Point: An individual who is facing an IRS levy against his or her plan benefit and who is not yet age 59½ should allow the IRS to follow through on the levy rather than voluntarily taking a plan distribution and paying it to the IRS in satisfaction of the unpaid taxes. A "voluntary" distribution would be subject to the 10 percent tax, whereas any amount distributed directly to the IRS pursuant to the levy would not. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

The cost of life insurance protection included in an employee's income (Q 3843) is not considered a distribution for purposes of applying the 10 percent penalty.[6] The Civil Service Retirement System is a qualified plan for purposes of the early distribution penalty.[7]

A plan is not required to withhold the amount of the additional income tax on an early withdrawal.[8] Distributions that are rolled over (Q 3880 to Q 3897) generally are not includable

1. IRC Sec. 72(t)(2)(G).
2. *O'Brien v. Comm.*, TC Summary Opinion 2001-148.
3. *Kute v. U.S.*, 191 F.3d 371 (3d Cir. 1999).
4. *Swihart v. Comm.*, TC Memo 1998-407.
5. See Let. Rul. 200426027.
6. Notice 89-25, 1989-1 CB 662, A-11.
7. *Roundy v. Comm.*, 122 F.3d 835, 97-2 USTC ¶50,625, *aff'g* TC Memo 1995-298; *Shimota v. U.S.*, 21 Cl Ct 510, 90-2 USTC ¶50,489 (Cl. Ct. 1990), *aff'd*, 91-2 USTC ¶50,400 (Fed. Cir. 1992).
8. General Explanation—TRA '86, p. 716.

in income, and, thus, the 10 percent penalty does not apply. In the case of a distribution subject to 20 percent mandatory withholding, the 20 percent withheld will be includable in income, however, to the extent required by IRC Section 402(a) or IRC Section 403(b)(1), even if the participant rolls over the remaining 80 percent of the distribution within the sixty day period (Q 3895). Thus, an employee who rolls over only 80 percent of a distribution may be subject to the 10 percent penalty on the 20 percent withheld.[1]

3861. How is an employee taxed on postretirement distributions from a qualified plan?

The tax treatment of distributions received at or after retirement depends on the time and manner of distribution.

If a distribution is rolled over to an IRA or other eligible retirement plan, the taxation of it is deferred until it is distributed in the future (Q 3880).

If a lump sum distribution is made, it is subject to the treatment explained in Q 3862 and, in the case of net unrealized appreciation on employer securities, as explained in Q 3863.

If an employee receives annuity payments, the benefits are taxed as explained in Q 539 and Q 540. The employee's cost basis, if any, is determined under the rules set forth in Q 3864.

If a distribution is received prior to age 59½, it may trigger the 10 percent penalty on early or premature distributions unless one of the exceptions applies (Q 3860).

3862. What is a lump sum distribution? What special tax treatment is available for a lump sum distribution from a qualified plan?

A distribution is a lump sum distribution if it:

(1) is made in one taxable year;

(2) consists of the balance to the credit of an employee;

(3) is payable on account of the employee's death, after the employee attained age 59½, or on account of the employee's separation from service; and

(4) is made from a qualified pension, profit sharing, or stock bonus plan.[2]

The classification will be relevant to certain distributions of employer securities that consist of net unrealized appreciations.

The distinction between lump sum distributions has become less important as fewer participants are able to use the pre-ERISA grandfather provisions for capital gain treatment of pre-ERISA accounts under a plan and certain income averaging rules that were repealed in 1986 (Q 544). The following discussion applies to the grandfathered tax treatment of

1. See Treas. Regs. §§1.402(c)-2, A-11, 1.403(b)-2, A-1.
2. IRC Sec. 402(e)(4)(D).

certain participant accounts that are conditioned on a distribution constituting a lump sum distribution.

The same requirements apply to distributions to self-employed individuals, except that full distributions made after a self-employed person has become disabled are considered lump sum distributions, and distributions made on account of "separation from service" are not.

The balance to the credit includes all amounts in the participant's account, including nondeductible employee contributions, as of the first distribution received after the triggering event.[1]

Certain eligible employees may elect ten-year averaging of certain lump sum distributions and special treatment of certain capital gains. For this purpose, an eligible employee is an employee who attained age fifty before January 1, 1986. Earlier IRC provisions that allowed for five year averaging of lump sum distributions were repealed for tax years beginning after 1999.

Ten-year averaging. An eligible employee makes a special averaging election by filing Form 4972 with his or her tax return; the election may be revoked by filing an amended return.[2] An eligible employee can make this election only once and it must apply to all lump sum distributions the employee receives for that year.

Under ten-year averaging, the tax on the ordinary income portion of the distribution is ten times the tax on 1/10 of the total taxable amount, reduced by the minimum distribution allowance. 1986 tax rates must be used, taking into account the prior law's zero bracket amount.[3] Generally speaking, the larger the distribution, the less likely that ten-year averaging will be advantageous.

Long-term capital gain treatment. An eligible employee also may elect capital gain treatment for the portion of a lump sum distribution allocable to his or her pre-1974 plan participation.[4] This portion is determined by multiplying the total taxable amount by a fraction, the numerator of which is the number of pre-January 1, 1974 calendar years of active plan participation and the denominator of which is the total number of calendar years of active plan participation.

For these purposes, the minimum distribution allowance is the lesser of $10,000 or one-half of the total taxable amount. This must be reduced by 20 percent of the total taxable amount in excess of $20,000. Thus, if the total taxable amount is $70,000 or more, there is no minimum distribution allowance. The total taxable amount is the amount of the distribution that exceeds the employee's cost basis (Q 3864). The employee's cost basis is reduced by any previous distributions excludable from his or her gross income.

1. Let. Ruls. 9031028, 9013009.
2. Treas. Reg. §11.402(e)(4)(B)-1.
3. TRA '86, Sec. 1122(h)(5); TAMRA '88, Sec. 1011A(b)(15)(B).
4. TRA '86, Sec. 1122(h)(3).

3863. How is net unrealized appreciation taxed when employer securities are distributed from a qualified plan?

Net unrealized appreciation ("NUA") is the excess of the fair market value of employer securities at the time of a lump sum distribution over the cost or other basis of the securities to a qualified plan trust.[1] Employer securities for this purpose include shares of a parent or subsidiary corporation.[2]

If employer securities are distributed as part of a lump sum distribution (Q 3862) from a qualified plan, the net unrealized appreciation is excluded from the employee's income at the time of distribution to the extent that the securities are attributable to employer and nondeductible employee contributions. Taxation of NUA following a lump sum distribution is deferred until the securities are sold or disposed of, unless the employee elects out of NUA treatment.[3] The election is made on the tax return for the year in which the distribution must be included in gross income and does not preclude an election for special income averaging.[4]

On a sale or other disposition of employer securities, the NUA amount is treated as long-term capital gain, regardless of the distributee's actual holding period. The taxpayer's basis in the stock is the same as the basis in the hands of the qualified plan trust; that is, it does not include the NUA amount.[5] Gain accruing after distribution of the securities and before the later disposition of them is treated as long-term or short term capital gain, depending on the holding period after distribution.[6] The distributee's holding period begins the day after the day the plan trustee delivers the stock to the transfer agent with instructions to reissue the stock in the distributee's name.[7]

Planning Point: The portion of the fair market value of the employer securities in excess of their net unrealized appreciation and the amount of the participant's after-tax contributions to the plan, if any, is included in income and potentially subject to the 10 percent tax, so that tax should be taken into account in determining whether and how much of the distribution should be rolled over to an IRA if the participant has not yet attained age 59½ and has separated from service before age fifty-five. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

An employer's shares, if acquired and credited to an employee's account, still are considered employer stock, even if later transferred to the trust of an acquiring or subsidiary corporation.[8] The basis does not change.[9] The balance of the value of the stock is taxable to the recipient under the regular rules for taxing lump sum distributions (Q 3862).[10]

1. See Treas. Reg. §1.402(a)-1(b)(2)(i).
2. IRC Sec. 402(e)(4)(E).
3. See IRC Sec. 402(e)(4)(B).
4. IRC Sec. 402(e)(4).
5. Treas. Reg. §1.402(a)-1(b)(1)(i).
6. See Treas. Reg. §1.402(a)-1(b); Notice 98-24, 1998-1 CB 929; see also Rev. Rul. 81-122, 1981-1 CB 202.
7. Rev. Rul. 82-75, 1982-1 CB 116.
8. Rev. Rul. 73-29, 1973-1 CB 198; Ltr. Rul. 201242019.
9. Rev. Rul. 80-138, 1980-1 CB 87.
10. See Rev. Rul. 57-514, 1957-2 CB 261.

Unrealized appreciation that is excluded from income is not includable in the recipient's basis in the stock for the purpose of computing gain or loss upon a later sale or other taxable disposition.[1] If part or all of the unrealized appreciation is excluded as something other than unrealized appreciation, only the part excluded as unrealized appreciation is not added to basis.[2]

Excluded appreciation prior to distribution that is realized on sale of the stock by the recipient of a distribution on account of the death of the employee or by a person inheriting the stock from the employee is income in respect of a decedent. As such, it is taxed as long-term capital gain and a deduction may be taken for the estate tax attributable to the inclusion of any part of the appreciation prior to distribution in the deceased employee's estate.[3]

Planning Point: In the case of divorce, be sure that the non-participant spouse has the QDRO drafted to specifically provide for an alternate payee to receive a pro-rata share of employer securities with the same cost basis; otherwise the ability to utilize NUA tax treatment may be lost. Many plans do not preserve this benefit for alternate payees in their sample QDRO language, so customized language may be required. *Helen Modly, CFP, ChFC, Focus Wealth Management, Ltd.*

NUA in employer securities distributed in other than a lump sum distribution is excludable only to the extent that the appreciation is attributable to nondeductible employee contributions.[4] Thus, a rollover of employer securities to an IRA will preclude the taxpayer from receiving NUA treatment.

A transfer to an IRA of less than all of a participant's account under an ESOP, with a distribution of the balance to the participant, does not bar treatment as a lump sum distribution, however. The IRS determined that a participant could exclude the net unrealized appreciation on the stock distributed until the participant disposes of it.[5]

Similarly, a participant who had received a series of substantially equal periodic payments (Q 3631, Q 3854) from his plan account prior to retirement was not precluded from treating a distribution of the remaining amounts, including stock, in his plan account as a lump sum distribution (Q 3859), nor from excluding net unrealized appreciation on the stock.[6]

3864. How is an employee's cost basis determined for an interest in a qualified plan ?

An employee normally will have no cost basis if a plan is noncontributory and does not provide life insurance protection.

If life insurance protection has been provided under a cash value policy, the employee usually will have some cost basis, namely, the aggregate one year term costs that have been taxed to the employee, even though the plan is noncontributory.[7]

1. Treas. Reg. §1.402(a)-1(b).
2. Rev. Rul. 74-398, 1974-2 CB 136.
3. Rev. Rul. 69-297, 1969-1 CB 131; Rev. Rul. 75-125, 1975-1 CB 254.
4. IRC Sec. 402(e)(4)(A).
5. Let. Ruls. 9721036, 200038057.
6. See Let. Rul. 200315041.
7. IRC Sec. 61(a)(1); Treas. Reg. §1.61-2(a)(1).

A self-employed person who is an owner-employee cannot include in his or her cost basis the annual one year costs of life insurance protection under Table 2001 or previously under P.S. 58 (Q 3843), even though these costs were not deductible.[1] No self-employed person, whether or not an owner-employee, can include in cost basis the cost of any health insurance features under the plan.

A common law employee's cost basis consists of:

(1) total nondeductible contributions made by the employee if the plan is contributory and amounts contributed by an S corporation for years beginning before January 1, 1984, on behalf of a more-than-5-percent shareholder-employee in excess of the excludable amount;

(2) the sum of the annual one year term costs of life insurance protection under Table 2001 or previously P.S. 58 (Q 3843) that have been includable as taxable income if payment is being received under the contract that provided the life insurance protection(Q 3847);

(3) any other employer contributions other than excess deferrals (Q 3705) that already have been taxed to the employee, such as where a nonqualified plan was later qualified;

(4) certain employer contributions attributable to foreign services performed before 1963; and

(5) the amount of any loans included in income as taxable distributions (Q 3848).

In addition, although amounts attributable to deductible employee contributions are not part of basis, it would seem they should be included in basis if benefits are received under the contract to the extent that they have been taxable to the employee because they were used to purchase a life insurance contract (Q 3847). This cost basis must be reduced by any amounts previously distributed to the employee that were excludable from gross income as a return of all or part of the employee's basis.[2]

A self-employed person's cost basis consists of (1) the nondeductible 50 percent of contributions made before 1968, after subtracting the cost of incidental benefits, if any, such as waiver of premium and health insurance benefits, and, in the case of an owner-employee, the costs of life insurance protection under Table 2001 or previously P.S. 58 (Q 3843), (2) contributions on behalf of owner-employees under the three year average rule for determining contributions to level premium insurance and annuity contracts in excess of the deductible limit, in effect for years beginning before 1984, and (3) nondeductible voluntary contributions, if any, to a contributory plan.

In addition, any amounts taxed to an individual because they were attributable to deductible voluntary employee contributions used to purchase life insurance, if benefits are received under the contract, probably should be included.

1. IRC Sec. 72(m)(2); Treas. Reg. §1.72-16(b)(4).
2. IRC Sec. 72(f); Treas. Regs. §§1.72-8, 1.72-16(b)(4), 1.402(a)-1(a)(6), 1.403(a)-2. See also Rev. Rul. 72-149, 1972-1 CB 218.

3865. When an employee dies before retirement, how is the employee's beneficiary taxed on a single sum cash payment of the death benefit payable under the employee's qualified plan?

If a death benefit is payable from the proceeds of a life insurance policy, the difference between the cash surrender value and the face amount is treated as death proceeds of life insurance, and is excluded from income under IRC Section 101(a), but only if the insurance cost under Table 2001 or previously under P.S. 58 (Q 3843) has been paid with nondeductible employee contributions or has been taxable to the employee.[1] The balance of the proceeds, representing the cash surrender value, is treated as a distribution from the plan.[2]

The following amounts may be subtracted from the cash surrender value and also excluded from gross income:

(1) the sum of the annual term costs of life insurance protection previously taxed to the employee (Q 3847), but if the deceased was a self-employed owner-employee, the deceased's beneficiary cannot subtract these costs even though they were not deductible by the owner-employee;

(2) if the plan is contributory, the employee's nondeductible contributions toward the cost of the insurance;

(3) the amount of any loans included in the employee's income as taxable distributions (Q 3848); and

(4) any employer contributions other than excess deferrals (Q 3705) that have been taxed to an employee, including contributions in pre-1984 years on behalf of a more-than-5-percent shareholder-employee in an S corporation in excess of excludable amounts.

The balance, if any, of the cash surrender value is taxable according to the rules applicable to lump sum distributions (Q 3862).

If an employer has purchased an existing policy from an employee for contribution to the trust, or if an employee has contributed it directly to the trust, the transfer for value rule (Q 264) does not apply so long as neither the employer nor the trustee has the right to change the beneficiary.[3]

Similarly, if a trustee of one plan purchases a life insurance policy from the trustee of another plan, there is no transfer for value where the beneficiary is entitled to designate the beneficiary both before and after the transfer because there has been no change in beneficial ownership.[4]

If a contract is a retirement income contract, and the cash surrender value before death equals or exceeds the face amount, no portion of the proceeds is excludable as death proceeds

1. Treas. Reg. §1.72-16(c)(4).
2. IRC Sec. 72(m)(3)(C); Treas. Reg. §1.72-16(c).
3. Rev. Rul. 73-338, 1973-2 CB 20; Rev. Rul. 74-76, 1974-1 CB 30.
4. Let. Rul. 7844032.

of life insurance.[1] The annual term costs of life insurance protection previously taxed to the employee would be excludable, except by the beneficiary of an owner-employee.

If the contract has been distributed to the employee before his or her death, the IRS has previously considered the proceeds entirely tax-exempt as life insurance proceeds, although the Tax Court has considered them taxable as proceeds payable under an annuity contract, because death occurs after the element of risk has disappeared.[2]

If a contract distributed before death is subject to the definition of life insurance in IRC Section 7702 or IRC Section 101(f), the treatment of the death benefit would be as discussed in Q 64.

If a death benefit is not from life insurance proceeds, the beneficiary may subtract and receive tax-free any nondeductible employee contributions, the amount of any loans included in income, and any employer contributions other than excess deferrals (Q 3705) that have been taxed to the employee. The balance, if any, of the death benefit, other than amounts attributable to deductible employee contributions, is taxable according to the rules applicable to lump sum distributions (Q 3862).

A distribution to an employee's beneficiary on account of plan termination, rather than on account of death, may not be treated as a lump sum distribution or as payment of an employee death benefit.[3]

A beneficiary may be entitled to an income tax deduction for any estate tax attributable to the distribution (Q 3877).[4]

3866. How is a beneficiary taxed on life income or installment payments of a death benefit under a qualified plan when an employee dies before retirement?

If a beneficiary has no cost basis for the payments, each payment will be fully taxable as ordinary income when received. The beneficiary's cost basis generally is the same as the employee's cost basis (Q 3864). In the case of decedents dying before August 21, 1996, the $5,000 death benefit exclusion was included in the beneficiary's cost basis.[5]

If the beneficiary does have a cost basis, payments are subject to the rules that follow, depending on whether the death benefits come from life insurance proceeds.

If death benefit payments do not come from life insurance proceeds, the beneficiary is taxed as the employee would have been taxed had the employee lived and received the periodic payments (Q 3859, Q 3860). The beneficiary's cost basis, rather than the employee's cost basis, is used. Depending on the annuity starting date, an exclusion ratio may have to be determined; if so, the beneficiary's cost basis is used as the investment in the contract

1. *Jeffrey v. U.S.*, 11 AFTR 2d 1401 (D. N.J. 1963).
2. See *Evans v. Comm.*, 56 TC 1142 (1971).
3. *Est. of Stefanowski v. Comm.*, 63 TC 386 (1974).
4. IRC Sec. 691(c).
5. Rev. Rul. 58-153, 1958-1 CB 43.

(for an explanation of the basic annuity rule and its application to various types of payments see Q 450 to Q 478). For annuities with a starting date on or before November 19, 1996, if a beneficiary elected the simplified safe harbor method for taxing annuity payments (Q 539) and increased the investment in the contract by any employee death benefit exclusion allowable, the beneficiary had to attach a signed statement to his or her income tax return stating that the beneficiary was entitled to such exclusion in applying the safe harbor method.[1] After such date, if the annuitant is under age 75, the simplified method is required, rather than optional.[2] When more than one beneficiary is to receive payments under a plan, the cost basis, including the $5,000 exclusion, if available, is apportioned among them according to each one's share of the total death benefit payments.

If death benefit payments do come from life insurance proceeds, the proceeds are divided into two parts: the amount at risk, which are proceeds in excess of the cash surrender value immediately before death, and the cash surrender value.[3]

The portion of the payments attributable to the amount at risk is taxable under IRC Section 101(d) as life insurance proceeds settled under a life income or installment option, as the case may be (Q 70). The amount at risk generally is prorated over the payment period, whether for a fixed number of years or for life, and the prorated amounts are excludable from the beneficiary's gross income as a return of principal.

Where payments are for life, the beneficiary's life expectancy generally is taken from IRS unisex annuity tables V and VI (Appendix A).[4]

The portion of the payments attributable to the cash surrender value is taxed in the same manner as any other periodic payments from a qualified plan.

Example: The widow of an employee who died on June 1, 2014, elects to receive $25,000 of life insurance proceeds in ten annual installments of $3,000 each. The cash surrender value of the policy immediately before the insured's death was $11,000. The employee made no contributions to the plan and the aggregate one year term costs of life insurance protection that were taxed to the employee amounted to $940. The widow must include $1,506 of each $3,000 installment, computed in the following manner.

Face amount of insurance contract	$25,000
Cash value immediately before death	11,000
Excludable as life insurance proceeds	$14,000
Portion of each installment attributable to life insurance proceeds (14/25 of $3,000)	$1,680
Excludable as return of principal ($14,000 ÷ 10)	1,400
Includable in gross income	$ 280

(If beneficiary is the surviving spouse of an employee who died before October 23, 1986, the $280 would be excludable under the $1,000 annual interest exclusion)

1. Notice 88-118, 1988-2 CB 450.
2. Notice 98-2, 1998-1 C.B. 266.
3. Treas. Reg. §1.72-16(c).
4. Treas. Reg. §1.101-7.

Portion of each installment attributable to cash surrender value of the contract (11/25 of $3,000)	$1,320
Beneficiary's cost basis ($940)	$940
Expected return (10 × $1,320)	$13,200
Exclusion ratio ($940/$13,200)	7.12%
Amount excludable each year (7.12% of $1,320)	$93.98
Includable in gross income ($1,320 – $93.98)	$1,226.02

The beneficiary may be entitled to an income tax deduction for any estate tax attributable to the decedent's interest in the plan (Q 3877).[1] It would seem that the deduction would be prorated over the beneficiary's life expectancy, in the case of life income payments, or over a fixed period, in the case of installment payments (Q 468).

3867. How is an employee's beneficiary taxed on death benefit payments from a qualified plan when the employee dies after retirement?

If an employee had no cost basis for his or her interest, or has recovered his or her cost basis from benefits received during the employee's life, all amounts received by the beneficiary will be fully taxable. The beneficiary may be entitled to an income tax deduction for any estate tax attributable to the employee's interest in the plan.[2]

Joint and Survivor Annuity

The method of taxing survivor annuity payments to a beneficiary depends on how the employee was taxed (Q 539).

If the employee was taxed on everything, the survivor annuitant will be taxed on everything as well.[3]

If the employee was taxed under the three year cost recovery rule in existence with respect to annuities with starting dates prior to July 1, 1986, and had not recovered his or her full cost basis, the survivor will receive the guaranteed payments tax-free until the total of the employee's and survivor's tax-free receipts equals the employee's cost basis; thereafter everything will be includable in gross income.[4]

If the employee was taxed under regular annuity rules or under the safe harbor method, the survivor will continue with the same exclusion ratio,[5] but if the employee's annuity starting date was after December 31, 1986, no amount is excludable by the employee or beneficiary after the investment in the contract has been recovered.[6]

1. IRC Sec. 691(c).
2. IRC Sec. 691(c).
3. Treas. Reg. §1.72-4(d).
4. Treas. Reg. §1.72-13.
5. Treas. Regs. §§1.72-4, 1.72-5.
6. IRC Sec. 72(b)(2).

Refund Beneficiary

If the employee had a cost basis for the employee's interest and had not recovered the full amount tax-free, a refund beneficiary under a life annuity with a refund or period-certain guarantee can exclude the balance of the cost basis from gross income (Q 539). Otherwise, everything received by the beneficiary is taxable.[1]

If the beneficiary receives the refund in a lump sum distribution, the lump sum distribution rules apply (Q 3862). If the beneficiary surrenders an annuity contract that has been previously distributed to the employee, the payment does not qualify for lump sum treatment because it is not viewed as a distribution from the trust but as a payment in settlement of the insurer's liability to make future payments.[2]

If the beneficiary receives the refund in installments, the payments are taxable as ordinary income.

If the refund beneficiary of a decedent whose annuity starting date was after July 1, 1986, does not fully recover the cost basis unrecovered at the decedent's death, the refund beneficiary may take a deduction for the remaining unrecovered amount.[3]

Installment Payments

Where payments for a fixed period or of a fixed amount, not involving a life contingency, had commenced to the employee, tax consequences to the beneficiary can differ, depending on whether the installments are continued or are commuted and paid to the beneficiary in a lump sum.

In addition, the balance, if any, of the lump sum payment is taxable under the lump sum distribution rules.

If installments are continued, the method of taxing payments then will depend on how the employee was taxed (Q 539). If the employee was taxed on everything, the beneficiary also will be.[4] If the employee was taxed under the three year cost recovery rule in existence for annuities with starting dates prior to July 1, 1986, and had not recovered his or her full cost basis tax-free, the beneficiary can exclude the balance from the first payments received. Thereafter, everything is taxable.[5]

If the employee was taxed under regular annuity rules or under the safe harbor method, the beneficiary will continue to exclude the same portion of each payment from gross income.[6]

If the annuity starting date was after December 31, 1986, the beneficiary can exclude amounts only until the investment in the contract has been fully recovered; thereafter, all amounts are included in income.[7]

1. Treas. Reg. §1.72-11; Treas. Reg. §1.72-13.
2. Rev. Rul. 68-287, 1968-1 CB 174.
3. IRC Sec. 72(b)(3).
4. Treas. Reg. §1.72-4(d).
5. Treas. Reg. §1.72-13.
6. Treas. Reg. §1.72-4(a).
7. IRC Sec. 72(b)(2).

3868. What general rules apply to withholding of income tax from qualified retirement plan benefits?

The withholding rules that apply to a distribution depend on whether it constitutes an eligible rollover distribution (Q 3882). An eligible rollover distribution from a qualified retirement plan is subject to mandatory income tax withholding at the rate of 20 percent unless the distribution is directly rolled over to an eligible retirement plan (Q 3883). An employee receiving an eligible rollover distribution may not otherwise elect out of this withholding requirement.[1]

On the other hand, a recipient may elect out of withholding with respect to distributions that do not qualify as eligible rollover distributions.[2] The amount to be withheld on periodic payments that are not eligible rollover distributions is determined at the rate applicable to wages.[3] Non-periodic payments that are not eligible rollover distributions are subject to income tax withholding at the rate of 10 percent.[4]

Withholding applies to amounts paid to a beneficiary of a participant as well as to the participant. Withholding does not apply to amounts that it is reasonable to believe are not includable in income.

The maximum amount withheld cannot exceed the sum of the money plus the fair market value of property received other than employer securities.[5] Thus, a payor will not need to dispose of employer securities to meet the withholding tax liability. Loans treated as distributions (i.e., deemed distributions) continue to be subject to withholding as non-periodic distributions at a rate of 10 percent. The IRS has stated that loans deemed to be distributions are not subject to the 20 percent mandatory withholding requirement because a deemed distribution cannot be an eligible rollover distribution. Where a participant's accrued benefit is reduced or offset to repay a plan loan, such as when employment is terminated, the offset amount may constitute an eligible rollover distribution.[6] Withholding is not required on the costs of current life insurance protection taxable to plan participants under Table 2001 or previously P.S. 58 (Q 3843).

3869. When are the earnings of a qualified pension or profit sharing trust taxable to the trust or to participants? When does trust income constitute unrelated business income?

Normally, neither a participant nor a trust pays any tax on earnings on a trust because as long as the plan meets the requirements of IRC Section 401(a), the trust is tax-exempt under IRC Section 501(a). The tax exemption also applies to trusts of plans covering self-employed individuals.

1. IRC Sec. 3405(c).
2. IRC Secs. 3405(a)(2), 3405(b)(2).
3. IRC Sec. 3405(a)(1).
4. IRC Sec. 3405(b)(1).
5. IRC Sec. 3405(e)(8).
6. See Notice 93-3, 1993-1 CB 293.

Trust income may be subject to income tax when it constitutes unrelated business income.[1] For example, a plan has unrelated business income from a trade or business regularly carried on by the trust.[2] This could occur when an exempt trust is a limited partner that receives unrelated business income to the same extent as if it were a general partner.[3] A specific deduction of up to $1,000 is allowed against unrelated business income.[4] Thus, a trust generally will pay income taxes when its unrelated taxable income exceeds $1,000.

Income from any type of property will be taxable as unrelated business income if the property has been acquired with borrowed funds, that is, debt-financed property. Thus, income from plan assets subject to debt, such as life insurance with policyholder loans, may give rise to unrelated business taxable income.[5]

Where a pension fund, in an attempt to increase the rate of return on three certificates of deposit, borrowed funds from a savings and loan with the three old certificates as collateral and was issued a new certificate in an amount equal to the borrowed amount, the net interest earned on the new certificate was income from debt-financed property.[6]

An exempt trust or 501(c)(3) organization may be a shareholder in an S corporation (Q 3740). Ordinarily, such an interest would be treated as an interest in an unrelated trade or business; thus, items of S corporation income paid to a plan could result in unrelated business income.

An employee stock ownership plan (Q 3739, Q 3747) maintained by an S corporation is not treated as receiving unrelated business income on items of income or loss of the S corporation in which it holds an interest.[7]

Employer securities purchased by an ESOP with borrowed funds do not give rise to unrelated business taxable income because the indebtedness that an ESOP incurs to purchase employer securities is inherent in the purpose of the trust's tax exemption.[8] Securities purchased on margin by a profit sharing trust and by a pension trust have been held to be debt-financed property.[9]

Where a trust is taxed because of its unrelated business income, the tax rate is the rate applicable to trusts.[10]

A trust's earnings are not entirely tax-free, but are merely deferred until they are distributed or made available to participants or their beneficiaries.[11]

1. IRC Sec. 511.
2. IRC Sec. 512.
3. *Service Bolt & Nut Co. Profit Sharing Trust v.* Comm., 724 F.2d 519 (6th Cir. 1983).
4. IRC Sec. 512(b)(12).
5. See *Siskin Memorial Found., Inc. v. U.S.*, 790 F.2d 480 (6th Cir. 1986), *aff'g* 603 F. Supp. 91 (E.D. Tenn. 1984); *Henry E. & Nancy Horton Bartels Trust v. United States*, 617 F.3d 1357 (Fed. Cir. 2010). See also Let. Rul. 7918095.
6. *Kern County Elec. Pension Fund v. Comm.*, 96 TC 845 (1991).
7. IRC Sec. 512(e)(3).
8. Rev. Rul. 79-122, 1979-1 CB 204.
9. *Elliot Knitwear Profit Sharing Plan v. Comm.*, 614 F.2d 347 (3d Cir. 1980).
10. See IRC Sec. 511(b); *Marprowear Profit Sharing Trust v. Comm.*, 74 TC 1086 (1980), *affirmed without opinion* (3d Cir. 1981).
11. IRC Secs. 402(a), 403(a).

3870. What is the tax treatment of reversions of trust assets to a plan sponsor?

The fair market value of any property reverting to an employer from a qualified plan is includable in the employer's gross income and generally is subject to a nondeductible excise tax.[1] The basic rule is that the excise tax is equal to 50 percent and is imposed on the amount of reversion that is subject to income taxes. The 50 percent tax rate can be reduced to 20 percent if the employer establishes or maintains a qualified replacement plan, provides for pro rata benefit increases for generally all participants and certain beneficiaries, or is in Chapter 7 bankruptcy liquidation as of the termination date of the qualified plan. Where the entire reversion is paid to a qualified replacement plan, there is no reversion to the employer, the employer pays no income taxes on the amount of the reversion, and as a result there is no excise tax.

A qualified replacement plan is any qualified plan established or maintained by the employer in connection with a qualified plan termination in which:

(1) at least 95 percent of the active participants in the terminated plan who remain employed by the employer are active participants;

(2) a direct transfer of assets is made from the terminated plan to the replacement plan equal to 25 percent of the maximum reversion that could have been received under prior law, reduced, dollar-for-dollar, by the present value of certain increases in participants' accrued benefits, if any, made pursuant to a plan amendment adopted during the sixty day period ending on the date of termination and taking effect on that date, before any reversion occurs; and

(3) the portion of the reversion transferred to a defined contribution replacement plan is allocated to participants' plan accounts in the plan year in which the transfer occurs or is credited to a suspense account and allocated to participants' accounts no less rapidly than ratably over the seven year period beginning with the year of the transfer.

If any amount credited to a suspense account cannot be allocated to a participant's account within the seven year period, such amount generally must be allocated to the accounts of other participants.[2]

The IRS has determined that where the above requirements were met, amounts transferred to a replacement plan could be used to make employer matching contributions.[3] If the entire surplus is transferred to a 401(k) plan that meets the requirements of a qualified replacement plan, the employer's excise tax on the reversion will be eliminated.[4] A profit sharing plan with

1. IRC Sec. 4980.
2. IRC Sec. 4980(d)(2).
3. Let. Ruls. 200045031, 9834036, 9302027.
4. Let. Rul. 9837036.

a 401(k) feature also has been approved as a qualified replacement plan.[1] None of the reversion, however, may be treated as employee salary deferrals.

Any amount transferred to a qualified replacement plan is not includable in the employer's gross income and is not treated as a reversion. No deduction is allowed with respect to the transferred amount.[2]

An employer is considered to provide for pro rata benefit increases for generally all plan participants and certain beneficiaries under the terminated plan if (1) a plan amendment is adopted in connection with the termination of the plan, (2) the pro rata benefit increases have an aggregate present value of not less than 20 percent of the maximum amount that the employer would otherwise have received as a reversion, and (3) the pro rata benefit increases take effect immediately on termination of the plan.[3]

Where a plan is amended to increase benefits in an effort to reduce the reversion, the benefits may not be increased, and amounts may not be allocated in contravention of the qualification requirements of IRC Section 401(a) or the IRC Section 415 limits (Q 3784, Q 3668, and Q 3677). Any such increases or allocations must be treated as annual benefits or annual additions under IRC Section 415.[4] The employer is determined on a controlled group basis and the Secretary of the Treasury may provide that two or more plans may be treated as one plan or that a plan of a successor may be taken into account.[5]

The tax applies to both direct and indirect reversions. An indirect reversion occurs where plan assets are used to satisfy an obligation of the employer.[6]

An employer maintaining a plan must pay the tax, which is due on the last day of the month following the month in which the reversion occurs.[7] Where money or property reverts to a sole proprietorship or partnership, the employer is the sole proprietor or the partners.

A distribution to any employer by reason of a contribution made in error may be permitted if one of three criteria is met: a mistake of fact has occurred, the funds are being returned because of a failure of the plan to qualify initially, or the error arose from a failure of employer contributions to be deductible and the repayment is permitted by the terms of the plan document.

A reversion from a multiemployer plan also will not be subject to the tax if made because of a mistake of law or the return of any withdrawal liability payment.[8] Although such a return to the employer may appear to be permitted under the IRC, it also must preclude creating a prohibited transaction under ERISA.

1. Let. Ruls. 9834036, 9252035.
2. IRC Sec. 4980(d)(2)(B)(iii).
3. IRC Sec. 4980(d)(3).
4. IRC Sec. 4980(d)(4).
5. IRC Secs. 4980(d)(5)(D), 4980(d)(5)(E).
6. See, e.g., Let. Rul. 9136017.
7. IRC Sec. 4980(c)(4).
8. IRC Sec. 4980(c)(2)(B).

A transfer of excess assets from a defined benefit plan to a defined contribution plan constitutes a reversion of assets to an employer if the assets were first transferred to the employer followed by a contribution to the defined contribution plan. Thus, excess assets are included in the employer's income and subject to the penalty tax.[1]

Although a qualified transfer of excess pension assets (Q 3756) from a defined benefit plan to an IRC Section 401(h) account of the plan is not treated as a reversion to the employer, any amount transferred and not used to pay for qualified current retiree health benefits must be returned to the transferor plan and generally is treated as a reversion subject to the 20 percent excise tax.[2]

3871. What are prohibited transactions?

Any transaction, whether direct or indirect, between a plan and a disqualified person (see Q 3872) constitutes a prohibited transaction under the IRC. These transactions include:

(1) a sale, exchange, or lease of any property, including a transfer of property subject to a security interest assumed by the plan or placed on it within ten years prior to the transfer;[3]

(2) lending of money or other extension of credit;

(3) furnishing of goods, services, or facilities; and

(4) the transfer of plan assets or income to, or use of them by or for the benefit of, a disqualified person.

Note, however, that there are statutory and regulatory exemptions from what would ordinarily be a prohibited transaction.

Planning Point: Before a plan enters any transaction, counsel should scrutinize the transaction to determine whether it is prohibited. If the transaction is prohibited, counsel should first determine whether a statutory exemption is available under ERISA Section 408. If so, counsel should make sure that each requirement is met, that the trustees approve the transaction and document the decision-making process in the plan's minutes, and that the transaction is adequately documented in writing. If no statutory exemption is available, then counsel should check class action exemptions to determine if one applies. Finally, if no other exemptions are available, counsel can apply for an individual exemption.[4]

It is a prohibited transaction for a disqualified person who is a fiduciary to deal with income or assets of a plan in his or her own interest or to receive consideration for his or her own personal account from a party dealing with the plan in connection with a transaction involving plan income or assets.[5]

1. Notice 88-58, 1988-1 CB 546; GCM 39744 (7-14-88).
2. IRC Sec. 420(c)(1)(B).
3. See IRC Sec. 4975(f)(3).
4. Final Department of Regulations on Prohibited Transaction Exemption Procedures are available at 29 C.F.R §§2570.30 – 2570.52.
5. IRC Sec. 4975(c)(1).

Title I of ERISA prohibits a fiduciary from acting, in any transaction involving the plan, on behalf of anyone having interests adverse to those of the plan or plan participants or beneficiaries.[1]

The Department of Labor has issued proposed regulations on ERISA Section 408(b)(2) disclosures.[2]

The definition of a plan for this purpose includes not only any qualified pension, profit sharing, stock bonus, or annuity plan, but also an individual retirement plan (Q 3602), health savings account ("HSA") (Q 369), Archer medical savings account ("MSA") (Q 387), or Coverdell education savings account. The term "plan" includes such plans even after they are no longer qualified. Government and church plans are excluded.[3]

3872. What is a "disqualified person" for purposes of the prohibited transaction rules?

A disqualified person is:

(1) a fiduciary;

(2) a person providing services to the plan;

(3) an employer or employee organization, any of whose employees or members are covered by the plan;

(4) a 50 percent owner, directly or indirectly, of an employer or employee organization described in (3);

(5) a family member of any person described in (1) through (4);

(6) a corporation, partnership, trust, or estate that is 50 percent or more owned by any person described in (1), (2), (3), or (5);

(7) an officer, director, 10 percent or more shareholder, or highly compensated employee of a person described in (3), (4), or (6); or

(8) a 10 percent or more (in capital or profits) partner or joint venturer of a person described in (3), (4), or (6).[4]

Fiduciary

A fiduciary is a person who has discretionary authority over plan management or administration or disposition of plan assets, or who renders investment advice for a fee or other compensation with respect to any money or other property of the plan.[5]

1. ERISA Sec. 406(b)(2).
2. 79 FR 13949.
3. IRC Sec. 4975(e)(1).
4. IRC Sec. 4975(e)(2).
5. IRC Sec. 4975(e)(3).

A person renders investment advice if he or she advises trustees as to the value of property or makes recommendations about the advisability of buying or selling property and, directly or indirectly (1) has discretionary authority with respect to buying or selling property, or (2) renders advice on a regular basis to the plan, pursuant to a mutual understanding that (x) the services will be the primary basis for investment decisions, and (y) he or she will render individualized advice regarding investment policies.[1] Whether advice and recommendations regarding plan purchases of insurance contracts and annuities constitute investment advice depends on the facts in each situation.[2] A fee or other compensation can include insurance sales commissions.

Under Department of Labor regulations issued in 2011, a person who develops a computer model or who markets a computer model or investment advice program used in an "eligible investment advice arrangement" is a fiduciary of a plan by reason of the provision of investment advice and is treated as a "fiduciary adviser."[3] The regulations specify the conditions that must be met for a fiduciary to elect to be the sole fiduciary adviser under the investment advice program.

ERISA does not modify the definition of a fiduciary under IRC Section 4975; consequently, an individual who is not a fiduciary under ERISA still can be a fiduciary for purposes of IRC Section 4975.[4]

Family Member

A family member is defined as a spouse, ancestor, lineal descendant, or any spouse of a lineal descendant.[5]

Highly Compensated Employee

A highly compensated employee is defined as any employee earning 10 percent or more of the yearly wages of an employer.[6]

3873. What exemptions to the prohibited transactions rules are provided by the Internal Revenue Code?

The IRC lists specific exemptions from the broad prohibited transaction rules. These include:

(1) the receipt of benefits under the terms of the plan;

(2) the distribution of the assets of the plan meeting allocation requirements;

(3) loans available to all plan participants or beneficiaries under certain circumstances (see Q 3874);

1. Treas. Reg. §54.4975-9(c).
2. Prohibited Transaction Exemption (PTE) 77-9 (Discussion of Major Comments).
3. DOL Regs. §2550.408g–2; IRC Sec. 4975(f)(8).
4. *Flahertys Arden Bowl, Inc. v. Comm.*, 115 TC 269 (2000), *aff'd*, 262 F. 3d 1162, 88 AFTR 2d 2001-5547 (8th Cir. 2001).
5. IRC Sec. 4975(e)(6).
6. IRC Sec. 4975(e)(2)(H).

(4) a loan to an employee stock ownership plan (Q 3739); and

(5) the acquisition or sale of qualifying employer securities by an individual account profit sharing, stock bonus, thrift, savings plan, or employee stock ownership plan for adequate consideration and without commission.[1]

Another statutory exemption is for the provision of office space or services necessary for the establishment or operation of the plan under a reasonable arrangement for no more than reasonable compensation.[2] This exemption shields only the provision of services that would be prohibited transactions under (1), (3), and (4) above, not fiduciary self-dealing. Thus, if an insurance agent is not a fiduciary, the agent's sale of insurance to a plan and receipt of a commission is within this statutory exemption. If an agent is a fiduciary (for example, if the trustee relies on his or her investment advice) receipt of a commission for sale of insurance or annuities to a plan may be a prohibited transaction.[3]

Certain administrative exemptions (see Q 3875) permit receipt of fees or commissions by fiduciaries in connection with the sale of insurance and annuity contracts to plans and the transfer of insurance contracts between plan and plan participants or employers.

Under regulations issued on February 3, 2012, compensation paid to certain service providers will not be considered reasonable for purposes of the prohibited transaction exemption without complying with a fee disclosure mandate.[4] The service providers covered by the mandate are fiduciaries, registered investment advisers, platform providers for participant directed defined contribution plans, and other indirectly compensated service providers such as an investment advisor to the plan. The initial compliance date for the required disclosures is July 16, 2011.[5] Failure to comply with the disclosure mandate will mean that compensation paid to the service provider no longer qualifies for the statutory prohibited transaction exemption.

Except for the first two exemptions listed above, these statutory exemptions do not apply where a plan that covers owner-employees (1) lends assets or income, (2) pays any compensation for personal services rendered to the plan, or (3) except as described in the following paragraph, acquires property from or sells property to (x) an owner-employee (Q 3829) or an employee who owns more than 5 percent of the outstanding shares of an S corporation, an individual retirement plan participant, beneficiary, or sponsoring employer or association, as the case may be, (y) a family member of a person described in (x), or (z) a corporation controlled by a person described in (x) through ownership of 50 percent or more of total combined voting power of all classes of stock or 50 percent or more of total shares of all classes of stock of the corporation.[6]

1. IRC Sec. 4975(d).
2. IRC Sec. 4975(d)(2).
3. PTE 77-9 (Discussion of Major Comments); see also Treas. Reg. §54.4975-6(a)(5).
4. 77 Fed. Reg. 5655.
5. Labor Reg. §2550.408b-2(c)(1)(vii).
6. IRC Sec. 4975(f)(6)(A).

A transaction consisting of a sale of employer securities to an ESOP (Q 3741) by a shareholder-employee, a member of his or her family, or a corporation in which he or she owns 50 percent or more of the stock generally will be exempt from the prohibited transaction rules. For this purpose, a shareholder-employee is an employee or officer of an S corporation who owns or is deemed to own, under the constructive ownership rules of IRC Section 318(a)(1), more than 5 percent of the outstanding stock of the corporation on any day during the corporation's taxable year.[1] For special rules applying to S corporation ESOPs that the IRS views as abusive, see Q 3747.

The Pension Protection Act of 2006 created an exemption from the prohibited transaction rules for certain fiduciary advisers who provide investment advice under an eligible investment advice arrangement (Q 3727).[2]

3874. When is a plan loan exempted from the prohibited transactions rules?

Loans made to plan participants and beneficiaries generally are exempted from the prohibited transaction rules if the loans:

(1) are made available to all participants and beneficiaries on a reasonably equivalent basis,

(2) are not made available to highly compensated employees (Q 3827) in an amount greater than the amount made available to other employees,

(3) are made in accordance with specific provisions regarding such loans set forth in the plan,

(4) bear reasonable rates of interest, and

(5) are adequately secured.[3]

A reasonable rate of interest is one that provides the plan with a return commensurate with the interest rates charged by persons in the business of lending money for loans made under similar circumstances.[4]

Security for participant loans is considered adequate if it may reasonably be anticipated that loss of principal or interest will not result if default occurs.[5] The effect of this no loss requirement varies depending on the type of plan; a plan in which the investment experience of the plan's assets is shared by all participants may require additional loan conditions, such as mandatory payroll deduction repayment on stated events or additional collateral.

1. IRC Secs. 4975(f)(6)(B)(ii), 4975(f)(6)(C).
2. IRC Secs. 4975(d)(17), 4975(f)(8).
3. ERISA Sec. 408(b)(1); IRC Sec. 4975(d)(1); Labor Reg. §2550.408b-1.
4. Labor Reg. §2550.408b-1(e).
5. Labor Reg. §2550.408b-1(f)(1).

No more than 50 percent of the present value of a participant's vested accrued benefit under a plan generally may be considered as security for the outstanding balance of all plan loans made to the participant.[1] Except in the case of directed investment loans, this loan exemption is not an exemption from the other fiduciary standards of ERISA. The prohibited transaction rules apply to a loan that does not meet the exemption requirements, even if it is treated and taxed as a distribution (Q 3848).[2]

Loans from a qualified plan to S corporation shareholders, partners, and sole proprietors generally are exempt from the prohibited transaction rules (Q 3848),[3] although there are rules applying to certain S corporation ESOPs that the IRS views as abusive (Q 3747).

The Tax Court determined that a loan between a plan and a corporation partially owned by a disqualified person did not constitute a prohibited transaction where the loan was approved by and made at the sole discretion of the plan's independent bank trustee.[4] A transfer of property to a plan in satisfaction of a participant loan was treated as a prohibited transaction where the borrower was a disqualified person.[5]

3875. What are the administrative exemptions to the prohibited transactions rules?

Administrative Exemption: 84-24

Prohibited Transaction Exemption 84-24[6] provides administrative relief in addition to the statutory provisions. It permits a life insurance agent, broker, or pension consultant and affiliates, including a fiduciary, who is a disqualified person (1) to receive sales commissions for insurance and annuity sales to a plan, or (2) to effect a transaction for the purchase of an insurance or annuity contract from an insurance company. The exemption also permits an investment company principal underwriter to effect a transaction for the purchase of an insurance or annuity contract. Furthermore, it allows the purchase of insurance or annuities from an insurance company that is a disqualified person. This class exemption is available only if certain conditions are met:

First, the transaction must be effected in the ordinary course of business of the agent, broker, or consultant on terms at least as favorable to the plan as those that would be negotiated in an arm's length transaction with an unrelated party. The total fees and commissions also must not be in excess of reasonable compensation, determined on a facts and circumstances basis.

Second, the agent, broker, consultant, or insurance company may not act as a plan trustee (other than a nondiscretionary trustee who does not render investment advice with respect to any assets of the plan), plan administrator, a fiduciary authorized to manage, acquire, or

1. Labor Reg. §2550.408b-1(f)(2).
2. *Medina v. U.S.*, 112 TC 51 (1999).
3. IRC Sec. 4975(f)(6)(B)(iii).
4. *Greenlee v. Comm.*, TC Memo 1996-378.
5. *Morrissey v. Comm.*, TC Memo 1998-443.
6. 1984-2 CB 231 (formerly PTE 77-9, 1977-2 CB 428, as amended by 1979-1 CB 371).

dispose of plan assets on a discretionary basis, or an employer, any of whose employees are covered by the plan. PTE 84-24, as amended, extends the same relief to situations where an affiliate of the insurance agent or broker, pension consultant, or investment company principal underwriter is a trustee with investment discretion over plan assets that are not involved in the transaction.[1]

The term affiliates includes (1) any person controlled by or under common control with the agent, broker, consultant, or insurance company, (2) any officer, director, employee, or relative of or a partner in (but not of) the agent, broker, consultant, or insurance company, and (3) any corporation or partnership of which the agent, broker, consultant, or insurance company is an officer, director, or employee, or in which he or she is a partner.

The transaction must be approved, in writing, by an independent fiduciary, who may be the employer. Prior to the sale, the agent, broker, or consultant must disclose to the independent fiduciary:

(1) the nature of the affiliation between the agent and the insurer whose contract is being recommended;

(2) any limitations on the agent's ability to recommend insurance or annuity contracts;

(3) the amount of sales commission, expressed as a percentage of gross annual premium payments for the first and renewal years; and

(4) a description of any charges, fees, discounts, penalties, or adjustments that may be imposed in connection with the purchase, holding, exchange, termination, or sale of such contracts.

Finally, the agent, broker, or consultant must retain records relating to the transaction for six years, but no filing is required with either the IRS or the Department of Labor. The records must be available for examination by those two federal agencies, plan participants, beneficiaries, and any employer or employee organization whose employees or members are covered by the plan.

An insurance company that is a service provider or fiduciary solely because it sponsors a master or prototype plan need satisfy only the first set of conditions. An agent, broker, or consultant who is a fiduciary and who sells insurance in connection with the master or prototype plan must meet both sets of conditions.

Administrative Exemption: 79-60

Prohibited Transaction Exemption 79-60[2] permits an insurance agent or broker who is the employer (or related, in certain ways listed below, to the employer) maintaining a plan to sell an insurance or annuity contract (including a contract providing only for the provision

1. See Amendment to PTE 84-24, 71 Fed. Reg. 5887 (Feb.1, 2006).
2. 44 Fed. Reg. 59018.

of administrative services) to the plan and receive a commission. A general agent who is the employer (or related to the employer in one of the listed ways) may receive override commissions on such sales by another agent.

The following three conditions must be met for a transaction to come within this exemption.

First, the agent or broker must be:

(1) an employer with employees covered by the plan (including a sole proprietor who is the only plan participant);

(2) a 10 percent or more partner of such an employer;

(3) an employee, officer, or director (or an individual having powers or responsibilities similar to those of officers or directors), or a 10 percent or more stockholder of such an employer;

(4) a 50 percent or more owner of the employer; or

(5) a corporation or partnership that is 50 percent or more owned by a plan fiduciary, a person providing services to the plan, the employer, a 50 percent owner of the employer, or an employee organization with members covered under the plan.

Second, the plan may pay no more than adequate consideration for the policy or contract.

Finally, the total commissions received in each taxable year of the agent or broker as a result of sales under this exemption must not exceed 5 percent of the total insurance commission income received by the agent or broker in that taxable year. There are no record-keeping requirements.

Administrative Exemption: 80-26

Prohibited Transaction Exemption 80-26[1] permits a disqualified person other than another plan to make unsecured interest-free loans to a plan to pay ordinary operating expenses (including the payment of benefits and periodic premiums under an insurance or annuity contract) or, for a period no longer than three days, for a purpose incidental to the ordinary operation of the plan. The Department of Labor adopted a temporary amendment to PTE 80-26 to include interest-free loans made to plans affected by the 9/11 terrorist attacks.[2] In 2006, the Department amended the regulation to eliminate the three-day limit, provided that if the loan is for longer than 60 days, the terms of the agreement are written.[3] An amendment proposed in 2013 would provide retroactive and temporary relief for certain guarantees of the payment of debits to plan investment accounts (including IRAs) by parties in interest to such plans as well as certain loans and loan repayments made pursuant to such guarantees.[4]

1. 1980-2 CB 323.
2. Temp. Amendments to PTE 80-26. 67 Fed. Reg. 9485 (Mar. 3, 2002).
3. 67 Fed. Reg. 17917 (April 7, 2006).
4. 78 Fed. Reg. 31584.

Administrative Exemptions: 92-5 and 92-63

Prohibited Transaction Exemptions 92-5 and 92-6[1] establish conditions for the transfer of life insurance and annuity contracts to and from plans. PTEs 92-5 and 92-6 extended the relief granted under PTEs 77-7 and 77-8 to owner-employees and to shareholders owning more than 5 percent of the outstanding stock in an S corporation. PTE 92-5 permits individual contracts to be transferred to a plan by participants or employers, any of whose employees participate in the plan. The plan generally must pay no more than the lesser of the cash surrender value of the contract or the value of the participant's accrued benefit at the time of the transaction (or account balance, in the case of a defined contribution plan), and the contract must not be subject to any loan that the plan assumes. The DOL has stated that where participants transfer individual policies that have no cash surrender value, the transfer will not violate the prohibited transaction rules where the plan pays no consideration for the policies.[2]

PTE 92-6 enables a plan to sell insurance contracts and annuities to a plan participant insured under the policies, a relative of such participant who is a beneficiary under the contract, an employer whose employees are covered by the plan, or another employee benefit plan for the cash surrender value of the contracts, provided certain conditions are met. In the absence of these exemptions, these transfers would be prohibited transactions.

PTE 92-6 first was clarified in 1998 so that, if all of its other conditions are met, two or more relatives who are the sole beneficiaries under a contract may be considered a single relative and an individual life insurance contract may be read to include a contract covering the life of the participant and his or her spouse (if permitted by applicable state insurance law, other applicable law, and pertinent plan provisions). In addition, a sale of a partial interest in a life insurance contract qualifies as a sale of an individual life insurance contract if certain requirements are met with both the portion sold and the portion retained.[3]

In 2002, PTE 92-6 was retroactively amended to permit transfers of life insurance contracts directly to life insurance trusts and certain other trusts.[4] In addition, the DOL clarified that second-to-die policies covering spouses are included within the scope of PTE 92-6.[5]

Planning Point: This expansion and liberalization by the Department of Labor adds trusts to the list of those to whom life insurance owned by a qualified plan can safely be sold. It is important to note that the exemption is conditioned on the fact that, but for the sale, the plan would have surrendered the life insurance contract. Furthermore, the plan must be paid what the policy is worth at the time it is sold.

The preamble to PTE 77-8[6] (which was replaced by PTE 92-6), noted that, for federal income tax purposes, the value of an insurance policy is not the same as, and may exceed, its cash

1. 57 Fed. Reg. 5019, 5189 (formerly PTEs 77-7 and 77-8, 1977-2 CB 423, 425).
2. DOL Adv. Op. 2002-12A.
3. See DOL Adv. Op. 98-07A.
4. See 67 Fed. Reg. 56313.
5. DOL Adv. Op. 2006-03A (February 26, 2006).
6. Citing Rev. Rul. 59-195, 1959-1 CB 18.

surrender value, and that a purchase of an insurance policy at its cash surrender value therefore may be a purchase of property for less than its fair market value.

In 2004 guidance, the Treasury Department clarified that under new proposed regulations, any such bargain element will be treated as a distribution under IRC Section 402(a) as well as for other purposes of the IRC, including the limitations on in-service distributions from certain qualified plans and the limitations of IRC Section 415.[1]

The DOL also has extended the application of PTE 92-6 to the transfer of a second-to-die policy owned by a husband and wife from a self-directed profit sharing plan account, provided certain requirements are met. Generally, the requirements are that the participant must be the insured under the contract, the contract would be surrendered but for the sale by the plan, and the amount received by the plan as consideration must be at least equal to the amount necessary to put the plan back in the same position as if it had retained the contract, surrendered it, and made any distribution owed to the participant on his or her vested interest under the plan.[2]

Administrative Exemption: 93-33 and 97-11

Prohibited Transaction Exemption 93-33[3] and Prohibited Transaction Exemption 97-11[4] allow banks and brokerages, respectively, to offer no or low cost services based on account balances in IRAs and Keogh plans, if certain requirements are met:

(1) the services offered must be those that could be offered under applicable state and federal law and that are available in the ordinary course of business to other customers who do not maintain an IRA or Keogh plan;

(2) the eligibility requirements, based on the account value or the amount of fees incurred, must be as favorable as any such requirements imposed on any other account included in determining eligibility to receive such services;

(3) the IRA or Keogh plan must be established for the exclusive benefit of the participant, his or her spouse, or their beneficiaries;

(4) the investment performance of the IRA or Keogh plan must equal or exceed that of a like investment made at the same time by a customer ineligible to receive such low or no cost services.

In addition, PTE 97-11 requires that the services offered by brokerages be the same as those offered to non-IRA or non-Keogh plan customers with like account values or like fees generated and that the combined total of all fees for the provision of services to the IRA or Keogh plan may not exceed reasonable compensation within the meaning of IRC Section 4975(d)(2).

1. See REG-126967-03, 69 Fed. Reg. 7384 (Feb. 17, 2004).
2. DOL Adv. Op. 2006-03A (February 26, 2006).
3. 58 Fed. Reg. 31053.
4. 62 Fed. Reg. 5855.

The Department of Labor subsequently adopted amendments expanding these exemptions to Coverdell education savings accounts and SIMPLE IRAs (Q 3654).[1] PTE 97-11 was similarly amended to extend its provisions to Roth IRAs, assuming they are not part of an employee benefit plan covered by Title I of ERISA, other than an SEP or a SIMPLE IRA.[2]

3876. What are the penalties for engaging in a prohibited transaction?

A first tier tax equal to 15 percent of the amount involved is imposed on each prohibited transaction for each year or part thereof from the time the transaction occurs until the earliest of the date: it is corrected, a deficiency notice is mailed, or the tax is assessed.[3] An employer fined under this provision for failing to make timely 401(k) transfer deferrals was assessed the 15 percent penalty only on the amount of interest the employer would have paid for a bank loan for the same amount, not 15 percent of the amount of the late deposit.[4]

All disqualified persons who participate in the prohibited transaction other than a fiduciary acting only as a fiduciary are jointly and severally liable for the full amount of the tax. A trustee was held liable for the tax even though the trustee did not vote to approve the payment that was determined to be a prohibited transaction; the Seventh Circuit Court of Appeals determined that the trustee had benefited from the payments and thus had participated in the transaction.[5]

An act of self-dealing involving the use of money or property, for example, the leasing of property, may be treated as giving rise to multiple transactions – one on the day the transaction occurs and separate ones on the first day of each taxable year within the above period – and, thus, may result in multiple penalties.[6]

Second Tier Tax

If a transaction is not corrected within the above period, there is a second tier tax of 100 percent of the amount involved. This tax will be abated if the transaction is corrected within ninety days after the notice of deficiency with respect to the additional tax is mailed. This ninety day period may be extended in certain circumstances.

To be corrected, the transaction must be undone to the extent possible, but, in any event, so as to place the plan in a financial position no worse than it would have been in had the disqualified person acted under the highest fiduciary standards.[7]

A prohibited transaction was held to be self-correcting, and thus not subject to the second tier tax (or to the first tier tax in subsequent tax years), where the extraordinary success of the investment was such that to undo the transaction would have put the plan in a worse position

1. See 64 Fed. Reg. 11042 and 64 Fed. Reg. 11044 (Mar. 8, 1999).
2. See 67 Fed. Reg. 76425 (Dec. 12, 2002).
3. IRC Sec. 4975(a); IRC Sec. 4975(f)(2).
4. See Rev. Rul. 2006-38, 2006-29 IRB 80.
5. *O'Malley v. Comm.*, 972 F.2d 150 (7th Cir. 1992).
6. Treas. Reg. §141.4975-13. See *Lambos v. Comm.*, 88 TC 1440 (1987).
7. IRC Secs. 4975(b), 4961.

than if the disqualified persons had acted under the highest fiduciary standards. Essentially, the transaction involved a sale of mineral rights that were producing over a million dollars a year in royalties to an ESOP by the employees of the employer in return for a private annuity.[1] The Tax Court considers this case to be an anomaly and has stated that, in general, prohibited transactions cannot be self-correcting.[2]

If the owner of an individual retirement account, or the owner's beneficiary, engages in a prohibited transaction and, as a result, the account ceases to be an individual retirement account, the tax does not apply (Q 3608). Similar rules apply to beneficiaries of health and Archer medical savings accounts (Q 369 to Q 387) and to beneficiaries of and contributors to education savings accounts.[3]

The IRS has the authority to impose tax penalties as a result of prohibited transactions, even when the Department of Labor has entered into a consent judgment concerning the plan.[4]

Qualified Plans and the Estate Tax

3877. Is the value of a death benefit payable from a qualified plan includable in the employee's gross estate?

In general, yes, if the employee dies after 1984.

Estates of Decedents Dying After 1984

The present value at the date of the decedent's death or at an alternate valuation date of an annuity or any other benefit payable to any surviving beneficiary under a qualified plan on the death of a participant, other than death proceeds of insurance on the participant's life, is includable in the decedent's estate.[5]

The Tax Reform Act of 1984 generally repealed the estate tax exclusion discussed below for estates of decedents dying after 1984. The repeal does not apply to the estate of any decedent who was a plan participant in pay status on December 31, 1984, and who irrevocably elected the form of the benefit before July 18, 1984.[6] The Tax Reform Act of 1986 provided that these conditions are considered met if the decedent separated from service before January 1, 1985, and does not change the form of benefit before death.[7] Qualified plan benefits rolled over to an IRA are treated as IRA benefits (Q 3659) that are not eligible for the TRA '86 separation from service rule.[8] For the meaning of the term "in pay status" and the requirements of an irrevocable election of the form of benefit, see Temporary Treasury Regulation Section 20.2039-IT.

1. *Zabolotny v. Comm.*, 7 F.3d 774 (8th Cir. 1993), *nonacq.* 1994-1 CB 1.
2. See *Morrissey v. Comm.*, TC Memo 1998-443.
3. IRC Sec. 4975(c)(3).
4. *Baizer v. Comm.*, 204 F.3d 1231 (9th Cir. 2000).
5. IRC Secs. 2039(a), 2039(b).
6. TRA '84, Sec. 525.
7. TRA '86, Sec. 1852(e)(3).
8. Rev. Rul. 92-22, 1992-1 CB 313; *Sherrill v. U.S.*, 415 F. Supp. 2d 953 (N.D. Ind. 2006).

Life insurance proceeds are includable under IRC Section 2042, assuming the participant held an incident of ownership in the insurance at his or her death or the proceeds are payable to or for the participant's estate. The right to name the beneficiary of the death proceeds is an incident of ownership (Q 81).

Estates of Decedents Dying After 1982 and Before 1985

Up to $100,000 in value of an annuity or other benefit payable to any surviving beneficiary under a qualified plan on the death of a participant, to the extent such value is attributable to employer contributions and to deductible employee contributions, is excludable from the gross estate, although special rules apply to a lump sum distribution.[1] The $100,000 limitation is an aggregate limitation applicable to survivor benefits payable under a qualified plan, a tax sheltered annuity (Q 553), an individual retirement plan (Q 3659), a Retired Serviceman's Family Protection Plan, or a Survivor Benefit Plan.

The Tax Reform Act of 1984 amended TEFRA to provide that the $100,000 limit shall not apply to the estate of any decedent who was a plan participant on pay status on December 31, 1982, and who irrevocably elected the form of benefit before January 1, 1983.[2] The Tax Reform Act of 1986 provided that these conditions are considered met if the decedent separated from service before January 1, 1983, and does not change the form of benefit before death.[3]

Estates of Decedents Dying After 1953 and Before 1983

The value of an annuity or other benefit payable to any surviving beneficiary under a qualified plan on the death of a participant, to the extent such value is attributable to employer contributions and to deductible employee contributions, is excludable from the gross estate, although special rules apply to a lump sum distribution.[4]

3878. Is a death benefit payable under a Keogh plan includable in a self-employed individual's gross estate?

Yes, generally, as to decedents dying after 1984.

Estates of Decedents Dying After 1984

The federal estate taxation of survivor benefits payable under a Keogh plan (Q 3749) is the same in the estate of a self-employed individual/participant as in the estate of a participant covered under a corporate plan (Q 3877).

1. IRC Secs. 2039(c), 2039(g), as amended and added by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and before repeal by the Tax Reform Act of 1984.
2. TRA '84, Sec. 525.
3. TRA '86, Sec. 1852(e)(3).
4. IRC Sec. 2039(c), before amendment by TEFRA.

Estates of Decedents Dying After 1953 and Before 1985

The federal estate tax exclusion (Q 3877) is available to the estates of self-employed individuals covered under qualified plans. For purposes of the exclusion, contributions or payments on behalf of the decedent participant while he or she was covered as a self-employed individual (Q 3829) are treated as employer contributions to the extent they were deductible as contributions to a qualified plan (Q 3837); to the extent they were not so deductible, such contributions or payments are treated as employee contributions.[1]

The exclusion applies only to amounts that are attributable to employer contributions[2] and to deductible employee contributions. In an insured plan, for example, the cost of current life insurance protection for self-employed participants is not deductible (Q 3847H); therefore, the at risk portion of the death proceeds of life insurance payable under the plan is not eligible for the estate tax exclusion. As to common law employees, on the other hand, the entire proceeds are eligible for the exclusion where the employer pays the cost.

3879. How does community property law affect the estate taxation of qualified plan benefits?

If an employee's interest in the employer's qualified plan is community property, then the interest is considered to be owned one-half by the employee and one-half by the employee's spouse. Accordingly, if the employee were to predecease the spouse, only the employee's community interest in any death benefit would be includable in the employee's estate (Q 3877). Likewise, if the employee's spouse were to die first, only the employee's spouse's community interest in the plan would be includable in the gross estate.[3]

The extent to which employee interests in qualified plans are community property is a matter of local law. There appears to be little doubt that an employee's vested interest in a qualified plan, to the extent it is attributable to contributions made while the employee was married and living in a community property state, is community property.[4] Moreover, there appears to be increasing support for the view that non-vested benefits in a retirement plan are not mere expectancies but are property, and thus can be community property.[5]

1. IRC Sec. 2039(c); Treas. Reg. §20.2039-2(c)(iii).
2. Let. Rul. 8122024.
3. IRC Sec. 2033.
4. *Herring v. Blakeley*, 385 S.W. 2d 843 (Tex. 1965); *Lynch v. Lawrence*, 293 So. 2d 598 (La. App. 1974, writs *ref'd.*); *T.L. James & Co., Inc. v. Montgomery*, 332 So. 2d 834 (La. 1976); *Everson v. Everson*, 537 P. 2d 624 (Ariz. App. 1975); *Marriage of Ward*, 50 Cal. App.3d 150 (1975); *Fox v. Smith*, 531 S.W. 2d 654 (Tex. Civ. App. 1975); 50 *Texas L. Rev*. 334 (1972); 17 *Loyola L. Rev*. 162 (1970-71); 24 *So. Calif. Tax Inst*. 469 (1972); 94 ALR3d 176.
5. *Johnson v. Johnson*, 638 P.2d 705 (Ariz. 1981); *Re Marriage of Brown*, 544 P.2d 561 (Cal. 1976); *Cearley v. Cearley*, 544 S.W. 2d 661 (Tex. 1976).