DC-1 STUDY GUIDE

PLAN QUALIFICATION AND COMPLIANCE BASICS

8TH EDITION

DEFINED CONTRIBUTION PLAN SERIES, VOLUME 1

The ASPPA Defined
Contribution Plan Series, Volume 1

PLAN QUALIFICATION AND COMPLIANCE BASICS

8th Edition

Excerpts taken from *The ERISA Outline Book*
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The ASPPA Defined Contribution Plan Series consists of three volumes:

Volume 1: Plan Qualification and Compliance Basics
Volume 2: 401(k) Plans and Intermediate Administration Topics
Volume 3: Advanced Compliance and Administration Topics

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8th Edition

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Notable Feature

The ASPPA Defined Contribution Plan Series is intended to serve a dual purpose: to provide educational materials to candidates preparing for examinations and to serve as a reference material.

In response to exam candidates' comments regarding the length of the books and difficulty distinguishing the material needed for examination purposes, we created the following heading to identify topics that are important to the subject being discussed, but will not be tested on the ASPPA DC-1 examination.

If You're Curious . . .

When you see the above heading, it is an indicator that the material included in the box, while important, will not be included on the examination.

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Section 1.01: Key Terms

- Advisory letter
- Anti-cutback rule
- Antiassignment rule
- Audit Closing Agreement Program (CAP)
- Closed year
- Delinquent Filer Voluntary Compliance (DFVC) Program
- Demographic failure
- Employee Plans Compliance Resolution System (EPCRS)
- Employer eligibility failure
- Exclusive benefit rule
- Favorable determination letter
- Individually designed plan
- Lead documents
- Nonamenders
- Operational failure
- Opinion letter
- Plan administrator
- Plan document failure
- Self-Correction Program (SCP)
- Summary of material modifications (SMM)
- Summary plan description (SPD)
- Trust
- Volume submitter plan
- Voluntary Fiduciary Correction Program (VFCP)
- Voluntary Correction with IRS Approval Program (VCP)

Section 1.02: Introduction

Qualified retirement plans are afforded favorable tax treatment, including tax deductible contributions, deferral of taxation to the employee, favorable tax treatment on distributions to employees and tax deferred investment earnings on plan assets. In order to be afforded this special treatment, qualified plans must satisfy certain requirements set forth in the Internal Revenue Code (IRC) and Treasury Regulations.

The body of law that governs retirement plans is the Employee Retirement Income Security Act of 1974, as amended (ERISA), which was comprehensive legislation that culminated after a decade of Congressional and Administrative discussion and consideration. ERISA is made up of four sections or Titles. Jurisdiction over retirement plans is split under ERISA between two Administrative Departments:

- the Department of Labor (DOL) [and its administrative agency, the Employee Benefit Security Administration (EBSA)]; and
- the Department of the Treasury [and its administrative agency, the Internal Revenue Service (IRS)].

Jurisdiction over the tax issues and qualification for the various tax benefits of being a qualified plan was given to the Treasury and the IRS. Jurisdiction over protecting participants' rights and governing fiduciary behavior was granted to the DOL and EBSA. (EBSA was originally called the Pension and Welfare Benefits Administration, or PWBA. The name was changed in 2003 to "more clearly communicate the agency's mission of protecting private sector employee benefits.")

This chapter outlines the general structure of ERISA, particularly focusing on the requirements for gaining tax qualification under the IRC and the benefits that are gained from this status. The chapter discusses the requirement that plan documents be in writing and how to ensure that the written document complies with IRS rules. Communicating the plan to the employees is another core requirement, and how this is done is discussed. The chapter then discusses the ramifications of a failure to maintain plan qualification. Finally, the chapter outlines the rules regarding the correction of qualification errors to keep the plan qualified.

Section 1.03: The Structure of ERISA

ERISA consists of four sections or Titles. They are:

TITLE I OF ERISA

Title I contains the labor law provisions of ERISA. These include the minimum standards for eligibility, vesting and funding. Reporting and disclosure rules and fiduciary standards are also prescribed by Title I of ERISA. The enforcement provisions of Title I empower the DOL, participants, beneficiaries and the plan fiduciaries to enforce the Title I requirements and to seek redress for violations.

TITLE II OF ERISA

Title II contains the tax-related provisions of ERISA that amended the IRC sections relating to qualified plans. The Title II requirements include provisions that parallel the Title I minimum standards for eligibility, vesting and funding.[1] There are also Title II sections that relate solely to the tax aspects of qualified plans and do not have parallel provisions in Title I [e.g., the coverage rules of IRC §410(b), the limitations under IRC §415 and the top-heavy rules under IRC §416].

TITLE III OF ERISA

Title III includes the administrative provisions of ERISA that divide enforcement responsibilities between the IRS and the DOL.

If You're Curious . . .

TITLE IV OF ERISA

This Title established the Pension Benefit Guaranty Corporation (PBGC), which provides an insurance program for defined benefit plans. Under certain circumstances, the PBGC will pay guaranteed benefits to participants on behalf of a defined benefit plan that terminates without sufficient assets to fulfill all benefit liabilities. Title IV also contains procedures that must be followed by a sponsor of a defined benefit plan when the plan terminates. Congress assigned responsibility to the PBGC for maintaining the defined benefits of lost participants.[2]

Congress later expanded that responsibility to include defined contribution plan lost participants.[3] This broadening of responsibility is not effective until the PBGC issues regulations explaining how the process will work for those plans and participants, which are still forthcoming. In 2013, the PBGC sent out a request for comments to the retirement plan community, seeking guidance as to how the defined contribution missing participants program should be structured. In September of 2016 the PBGC released proposed regulations on the program, however, it will not be implemented until the regulations are finalized (which has not been done as the preparation of this materials)

Section 1.04: Basic Plan Qualification Requirements

This book discusses various rules relating to qualified plans. But, what exactly is a qualified plan? The technical definition is: a plan that satisfies the requirements of IRC §401(a). IRC §401(a) lists the myriad requirements with which a qualified plan and its sponsor must comply to obtain the available tax advantages of having the plan.

Qualified plans may take several forms, including defined benefit plans, profit sharing plans, money purchase plans, 401(k) plans and stock bonus plans. A qualified annuity plan under IRC §403(a) is also treated as a qualified plan.

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[1] IRC §§410(a), 411 and 412.

[2] ERISA §4050.

[3] PPA §410, amending ERISA §4050.

FORM AND OPERATIONAL REQUIREMENTS

The IRC §401(a) requirements must be satisfied in form and in operation. Compliance in form means the plan document includes the relevant provisions of IRC §401(a). Treas. Reg. §1.401-1(a)(2) requires the plan to be a definite written program. Failure to satisfy the form requirement is grounds for disqualification, even if the plan is operated properly.[4] Plan document violations may be corrected within a certain time frame, called the remedial amendment period. If the remedial amendment has expired, the problem may be resolved under the Voluntary Correction with IRS Approval Program (VCP), which is part of the IRS's Employee Plans Compliance Resolution System (EPCRS), an articulated program under which a plan sponsor may correct qualification problems. These correction processes are discussed later in this chapter.

LISTING OF REQUIREMENTS

All the requirements to be a qualified plan are described or cross-referenced in IRC §401(a). Governmental plans and nonelecting church plans (i.e., church plans that have not elected to be covered by Title I of ERISA) are exempt from several of the IRC §401(a) requirements.

If You're Curious . . .

Many of the qualification requirements are set out in more detail in another IRC section that is cross-referenced by IRC §401(a). The most important of these are IRC §410 (eligibility and coverage requirements), IRC §411 (vesting requirements), IRC §415 (limitations on contributions and benefits), IRC §416 (top-heavy rules) and IRC §417 (joint and survivor annuity requirements). Other "400" sections of the IRC that are not cross-referenced in IRC §401(a) usually deal with tax issues (e.g., IRC §404 addresses the employer's limit on tax deductions for contributions to qualified plans) or definitional requirements {e.g., IRC §414 provides definitions for a host of terms, such as highly compensated employee (HCE) [IRC §414(q)] and a controlled group of businesses [IRC §414(b) and (c)]}.

The following list briefly summarizes the subsections of IRC §401(a) that impact defined contribution plans:

IRC §401(a)(1) (Plan must be for Employees)

The qualified plan must be for the employees of the employer. Independent contractors may not be covered by the plan. The term "employee" includes a self-employed individual of a sole proprietorship or partnership.

For these rules to be met, the plan must be sponsored by an employer. The word "employer" has different meanings for the IRC than it does for ERISA.

If You're Curious . . .

Definition of Employer for Tax Qualification Purposes

For purposes of IRC §401(a), the employer is any employer (under common law principles) of the employees covered by the plan. The IRS maintains that a plan ceases to be a qualified plan if the sponsoring employer goes out of business, unless a successor employer takes over sponsorship of the plan. Such a plan is known as an orphan plan. This will be discussed below.

A self-employed individual may be treated as an employee of the trade or business with respect to which he or she is a self-employed individual within the meaning of IRC §401(c)(1). The trade or

[4] *Basch Engineering, Inc. v. Commissioner*, 59 T.C.M. 482 (1990).

business is the employer that must maintain the qualified plan that covers the self-employed individual. If the trade or business is a sole proprietorship, the employer is the sole proprietor (i.e., the sole proprietor is both the employer and an employee of the employer). If the trade or business is a partnership, the individual partners are treated as self-employed individuals, but it is the partnership that is the employer and it is the partnership that must establish the plan (i.e., the individual partners are treated as employees but the partnership is the employer).[5]

If the employer that maintains the plan is related to another company under the controlled group of businesses definition in IRC §414(b) or (c) because of common ownership or under the affiliated service group definition in IRC §414(m) because of common ownership and the joint provision of services, the related company is also treated as an employer of the employees covered by the plan for certain purposes, regardless of whether the related company also maintains the plan.

Definition of Employer for ERISA Purposes

Pursuant to ERISA §3(5), the employer is "any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan." The term also includes a group or association of employers acting for an employer in such capacity. A sole proprietorship or partnership is an employer for ERISA purposes only with respect to its common law employees. For ERISA purposes, neither a sole proprietor nor a partner is treated as an employee.

Participating Employer

There may be more than one employer with respect to a plan (i.e., some plans are co-sponsored by more than one employer). When two or more employers maintain a single plan, all the participating employers might be signatories on the execution page(s) of the plan document or there might be one employer on the execution page and each additional participating employer executes a separate adoption page or participation agreement. All the participating employers in the plan are treated as an employer with respect to the plan. When the employers are related employers, the plan is considered to be a single-employer plan because the related employers are treated as one employer. When at least two of the employers that sponsor the plan are not part of a related group, the plan is called a multiple employer plan or, if the plan is collectively bargained, a multiemployer plan.

Orphan Plans

An orphan plan is a plan without an existing sponsoring employer. The IRS has stated informally at numerous employee benefits conferences that IRC §401(a)(1) requires the existence of an employer for a plan to be a qualified plan. If the sponsoring employer goes out of existence, the plan ceases to be a qualified plan, unless a successor employer takes over sponsorship of the plan.

DOL's definition of orphan plan. The DOL defines an orphan plan as a plan that has no one with authority to operate the plan due to:

1. Death or absence of the persons designated as fiduciaries;
2. Neglect to appoint successor fiduciaries; or
3. Corporate mergers or bankruptcies.

EBSA has published a Fact Sheet on Orphan Plans at the EBSA website (www.dol.gov/ebsa). EBSA may be contacted regarding orphan plans at 1-866-444-EBSA (3272), which is a toll-free number.

The DOL has an enforcement program that has helped return over $200 million to workers covered under orphan plans. Where appropriate, the abandonment of the plan has led to DOL civil and crim-

[5] IRC §401(c)(4).

inal investigations, under which existing plan fiduciaries are located to take over management of the plan, even if it is just to supervise the termination and liquidation of the plan. The DOL has developed procedures where certain persons other than the plan sponsor can initiate the termination and liquidate a defined contribution orphan plan.[6]

IRC §401(a)(1) (Assets must be Held in Trust)

IRC §401(a)(1) also requires that plan assets be held in **trust**. A trust is a separate legal entity that holds title to assets set aside on behalf of beneficiaries. The written trust document outlines who is entitled to benefit from trust assets. Furthermore, the trust is administered by a trustee, who is responsible for safeguarding and investing the funds for the beneficiaries.

IRC §401(a)(2) (Exclusive Benefit Rule)

A plan must be maintained for the exclusive benefit of the participants and their beneficiaries.[7] This rule is known as the **exclusive benefit rule**. It prohibits the employer from diverting the assets for its own benefit. The fact that an employer receives tax benefits from the maintenance of the plan (e.g., an income tax deduction for the contributions) does not violate the exclusive benefit rule.

Almost every rule has exceptions, and the exclusive benefit rule is no different. Under certain circumstances, an employer may receive a return of contributions made to the plan. In addition, the payment of expenses from the plan, although not providing benefits to the plan participants, is permissible under the exclusive benefit rule, as long as the expenses are reasonable and relate to the administrative or fiduciary operations of the plan. An isolated instance of imprudent investment activity does not alone create a violation of the exclusive benefit rule.

If You're Curious . . .

Common Law Employer/Employee Relationship Issue

Note that the exclusive benefit rule also requires that qualified plan participants be employees (or former employees) of the employer that sponsors the plan. The exclusive benefit rule is violated if nonemployees are allowed to participate. For example, independent contractors may not participate in the qualified plan of the company for whom the independent contractor provides services in such capacity. There is a statutory exception in IRC §401(c) for self-employed individuals (i.e., sole proprietors, partners) who derive earned income from the unincorporated business (e.g., sole proprietorship, partnership) that sponsors the plan.

Leasing organizations/PEOs. A leasing organization might sponsor a plan that covers leased employees, within the meaning of IRC §414(n), who provide services to one or more recipient employers (i.e., clients of the leasing organization). However, in some cases, a purported leasing organization [usually referred to as a professional employer organization (PEO) or staffing firm] is not actually the common law employer of the individuals who provide services to the client organizations. Instead, the client organization is the actual common law employer. In such case, if the PEO maintains a qualified plan that covers individuals who are actually the common law employees of the client organizations, but the client organizations do not also sponsor that plan through a multiple employer plan arrangement, the PEO's plan violates the exclusive benefit rule and is not qualified.[8]

[6] DOL Reg. §2578.1, Appendixes A through D to §2578.1, §2520.103-13, 71 F.R. 20820, 20828-20830, 20850-20853 (April 21, 2006).
[7] IRC §401(a)(2); ERISA §404(a)(1).
[8] Rev. Proc. 2002-21, IRB 2002-18 (May 6, 2002).

Return of Contributions to the Employer

When the employer contributes to the plan, that contribution generally is irrevocable. If the employer could take back the contribution, the participants' accrued benefits would be compromised. However, under specific circumstances, a return of contributions to the employer is permissible. Pursuant to Rev. Rul. 91-4,[9] contributions may be returned if:

- the contributions are made under a mistake of fact;
- there is a disallowance of the deduction taken for the contributions or
- the contributions are made to a plan that fails to initially qualify under IRC §401(a).

Parallel rules are found in ERISA §403(c)(2). If there is a mistake of fact or a disallowance of deduction, the contributions must be returned no later than 12 months after the mistake or disallowance. Different rules apply to multiemployer plans.

Earnings on the contributions may not be returned if the reversion is due to a mistake of fact or disallowance of deduction. However, if there has been a net investment loss on the contributions, the amount returned must be reduced by the amount of such loss. In the case of a reversion due to initial disqualification of the plan, the entire assets of the plan are subject to reversion, including any earnings on contributions that have been made prior to the issuance of the adverse determination letter.[10]

Mistake of fact. The IRS has not defined a mistake of fact. In Private Letter Ruling (PLR) 9144041, the IRS suggested that only mathematical or typographical errors generally will fall into this category. Merely because a contribution by the employer is not currently deductible [e.g., profit sharing contribution exceeds the deduction limit under IRC §404(a)(3)] does not make the contribution a mistake of fact.[11]

Disallowance of deduction. The IRS interprets this exception to mean that the IRS actually must disallow a deduction claimed by the employer, not that the employer determines its contribution is not deductible. Where a nondeductible contribution is made to a defined benefit plan, the employer may apply for a disallowance ruling from the IRS so that the employer may have the nondeductible contribution returned.[12] This procedure, however, applies only to defined benefit plan contributions that were made to satisfy the quarterly contribution requirement under IRC §412(m). If the amount of the nondeductible contributions is $25,000 or less, the nondeductible amount may be returned without having to obtain an IRS ruling.[13]

Failure to obtain initial qualification on new plan. A reversion for failure to initially qualify is applicable only if the plan fails to qualify retroactive to its original effective date. In such case, all plan assets may revert to the employer. For this exception to apply, the following conditions must be satisfied:

1. Contributions to the plan are conditioned on obtaining initial qualification;
2. The plan receives an adverse determination letter with respect to its initial qualification; and
3. The application for a determination letter is filed within the applicable remedial amendment period that applies to the initial plan year.[14] If the plan is amended after it receives its initial qualification letter and such amendment causes the plan to become disqualified, this exception does not apply.

An employer might use this exception to reverse the adoption of a plan that is inappropriate for the employer. If the plan is timely submitted for its initial determination letter, and an adverse determination is made, the employer may have the entire fund reverted and no benefits are owed to the participants (other than contributions made by the participants).

Payment of Plan Expenses With Plan Assets

A plan may pay expenses relating to reasonable expenses of administering the plan, including investment management

[9] 1991-1 C.B.57.
[10] Rev. Rul. 91-4, 1991-1 CB 57 (January 1, 1991).
[11] IRS Notice 89-52, Q-16, 1989-1 C.B. 692.
[12] Rev. Proc. 90-49, 1990-2 C.B. 620.
[13] Rev. Proc. 90-49, §4.
[14] ERISA §403(c)(2)(B).

or trustee fees, recordkeeping fees and reporting and disclosure expenses incurred by the plan.[15] The DOL has issued only piecemeal guidelines in this area.[16] Some guidance can be found in the DOL publication "Understanding Retirement Plan Fees. This publication can be found on their website at http://www.dol.gov/agencies/about-ebsa/our-activites/resource-center/publications/understanding-your-retirement-plan-fees.

IRC §401(a)(3) and IRC §401(a)(6) (Minimum Age and Service Requirements/Coverage)

A qualified plan may not impose age and service requirements that are more stringent than those permitted by IRC §410(a). A qualified plan also must cover a fair cross-section of employees, as demonstrated by satisfying the minimum coverage requirements under IRC §410(b).

IRC §401(a)(4) and IRC §401(a)(5) (Nondiscrimination Testing)

A qualified plan must not discriminate in favor of highly compensated employees (HCEs). Special nondiscrimination testing rules are prescribed by IRC §401(k) and IRC §401(m) for elective deferrals, matching contributions and after-tax employee contributions. The IRC §401(k) nondiscrimination test (the actual deferral percentage or ADP test) applies to elective deferrals (both pre-tax and designated Roth) under a 401(k) arrangement, and the IRC §401(m) nondiscrimination test (the actual contribution percentage or ACP test) applies to after-tax employee contributions and to employer matching contributions.

IRC §401(a)(7) (Minimum Vesting Standards)

A plan must satisfy the minimum vesting standards under IRC §411, which includes vesting schedule requirements, forfeiture and break-in-service rules and vesting requirements for partial or complete termination of a plan. Other qualification requirements found in IRC §411 include consent requirements for certain plan distributions and the prohibition against the reduction of benefits by amendment (known as the **anti-cutback rule**).

IRC §401(a)(9) (Minimum Distribution Rules)

A qualified plan must commence the payment of benefits no later than the required beginning date prescribed by IRC §401(a)(9), which is wholly or partly determined by when the employee attains age 70½.

IRC §401(a)(10) (Top-Heavy Rules)

A qualified plan must satisfy special vesting and accrual requirements if the plan is top-heavy.

IRC §401(a)(11) (Joint and Survivor Rules)

A qualified plan must provide a qualified joint and survivor annuity (QJSA) to a participant unless certain notice and consent requirements are satisfied. Most profit sharing plans, stock bonus plans and 401(k) plans are not subject to this requirement.

IRC §401(a)(12) (Mergers and Transfers)

Certain requirements for protecting benefits must be satisfied in a plan merger or in a transfer of plan assets and liabilities.

IRC §401(a)(13) (Antiassignment Rule)

A participant's accrued benefit is protected from assignment or alienation.[17] This is called the **antiassignment rule** and

[15] ERISA §404(a)(1)(A)(ii).
[16] DOL Opinion Letters 97-03A, 2001-01A.
[17] IRC §401(a)(13); ERISA §206(d).

the protection extends to garnishment, levy, execution or other legal or equitable process by the participant's creditors.[18] The trust assets also are protected from the employer's creditors because the trust assets are held for the exclusive benefit of the participants and their beneficiaries and are not part of the employer's general assets.

Exceptions

The law and regulations provide for some exceptions to the antiassignment rule. These exceptions include:

- federal tax levies;
- participant loans;
- QDROs;
- certain voluntary assignments; and
- offset of participant's benefit for fiduciary breach.

If You're Curious . . .

Federal tax levies. The IRS may enforce a tax levy against the plan benefit, pursuant to IRC §6331.[19] When a plan administrator (or trustee) receives a tax levy from the IRS, legal counsel should be consulted on how to proceed. If the participant is already in pay status, the administrator (or trustee) will generally honor the levy. If the participant is not in pay status, the plan administrator (or trustee) might want to get express direction from the IRS to turn over plan assets that are not in pay status under the plan. The IRS will usually wait until either the participant has elected to take a distribution from the plan, or the participant is entitled to distribution and the IRS elects for him or her.

The distribution of plan assets to the IRS pursuant to a tax levy constitutes the satisfaction of a legal obligation of the participant.[20] Accordingly, it is subject to taxation in accordance with the rules under IRC §72. Any distributions made pursuant to the levy are taxable distributions, subject to the normal rules regarding income tax liability, including withholding.

The exception for federal tax levies does not apply to state tax levies. Therefore, a participant's benefits are protected from a tax levy by a state taxing authority. The trustee should refuse to pay plan benefits pursuant to such a levy.

Participant loans. It is not a violation of the antiassignment rule for a plan to allow a participant to use his or her accrued benefit as security on a participant loan.[21] This exception applies only if the loan is from the plan. In other words, the participant may not secure a loan from a bank with his or her accrued benefit. The bank would not have an enforceable security interest against the participant's plan benefits in the event the participant defaulted on the loan. A participant loan made by the plan must satisfy the prohibited transaction exemption requirements of IRC §4975(d)(1). If those requirements are not satisfied, the plan has violated the antiassignment rule by securing a nonexempt loan with the participant's accrued benefit, resulting in plan disqualification.[22]

Furthermore, a plan loan that does not comply with the conditions under IRC §72(p)(2), while not being a violation of the antiassignment rule, may result in the loan being taxed to the participant as if it were a distribution. If a participant pledges or assigns his or her benefit to a third party, the amount assigned or pledged is treated as a loan under IRC §72(p), resulting in tax consequences unless the conditions of IRC §72(p)(2) are satisfied.

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[18] Treas. Reg. §1.401(a)-13(b)(1).

[19] Treas. Reg. §1.401(a)-13(b)(2). Also see Shanbaum v. U.S., 32 F.3d 180 (5th Cir. 1994), Schaffer v. U.S., 97-2 USTC ¶50,621 (Bkrtcy. D. Idaho June 3, 1997), and In re Perkins, 134 B.R. 4B (Bkrtcy. OUTCALL.1991).

[20] PLR 200426027.

[21] Treas. Reg. §1.401(a)-13(d)(2).

[22] Treas. Reg. §1.401(a)-13(d)(2)(iii).

QDROs. A qualified domestic relations order (QDRO) is exempt from the antiassignment rule.[23] A QDRO is a court order that provides for the payment of all or a portion of the participant's benefits to an alternate payee. The alternate payee may be a spouse, a former spouse or a child or other dependent of the participant.

The IRS will allow a QDRO to create a security interest in the participant's benefit to secure nonplan obligations to the alternate payee. The form requirements for a QDRO still need to be satisfied before the order to secure nonplan obligations may be recognized by the plan as a QDRO.

Certain voluntary assignments. A participant or beneficiary who is receiving benefits under the plan may have obligations to third parties that he or she wishes to satisfy with those benefit payments. The regulations under IRC §401(a)(13) provide voluntary mechanisms to facilitate the payment of third party obligations with benefit payments.

Treasury Regulations permit a participant or beneficiary to direct the plan to pay all, or any portion, of a benefit payment to a third party (which may include the individual's employer) if the following conditions are satisfied:

1. The arrangement must be revocable; and
2. The third party must file a written acknowledgment with the plan administrator.[24]

The written acknowledgment must state that the third party has no enforceable right in, or to, any plan benefit payment.[25] The arrangement may only apply to a particular payment. A continuing arrangement with respect to future payments is subject to the limitations described below.

EXAMPLE 1-1. Voluntary Assignment of Benefit. Lester is receiving a lump-sum distribution from his employer's profit sharing plan. The lump-sum distribution is for $40,000. Lester owes $8,000 to Creditor X. He enters into an arrangement that satisfies the above requirements to have $8,000 of his distribution paid directly to X. The payment of $8,000 to X under this arrangement is not a violation of the antiassignment rule.

A plan may provide that, once benefits are in pay status, the participant or beneficiary may assign the right to future benefit payments, provided that:

1. The assignments are revocable;
2. They do not involve more than 10 percent of any benefit payment; and
3. The assignments are not for the purpose, nor have the effect of, defraying plan administration costs.[26]

This exception provides for an ongoing payment of up to 10 percent of the participant's benefit payments to a third party.

EXAMPLE 1-2. Assignment of Benefits in Pay Status. Miriam is receiving annuity payments from her employer's defined benefit plan. Her payments are $4,000 per month. Miriam has a car loan with monthly payments of $200. She enters into a revocable assignment of $200 of each monthly payment directly to the holder of the car loan. The antiassignment rule is not violated because the arrangement is revocable and does not involve more than 10 percent of Miriam's future annuity payments.

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[23] IRC §414(p); ERISA §206(d)(3).
[24] Treas. Reg. §1.401(a)-13(e)(1).
[25] Treas. Reg. §1.401(a)-13(e)(2).
[26] Treas. Reg. §1.401(a)-13(d)(1).

A participant or beneficiary who enters into one of the permitted assignments is still liable for the applicable taxes on the distribution, as if the full benefit payments had been made to the participant or beneficiary. The purpose of these assignments is to shortcut the process of paying the third party, not to shift tax liability.

Offset of participant's benefit for fiduciary breach. IRC §401(a)(13)(c) and ERISA §206(d)(4) permit the offset of a participant's benefits under a plan for an amount the participant is required to pay because of:

1. A judgment resulting from conviction for a crime involving such plan;
2. A civil judgment involving ERISA fiduciary rules; or
3. A settlement agreement with the DOL or PBGC.

The judgment, order, decree or settlement must expressly provide for offset against the participant's benefit. If the joint and survivor annuity rules apply to the participant's benefit, the survivor annuity rules are satisfied even though the offset occurs, but only if:

1. The spouse consents in writing to the offset or an election to waive the survivor rights is in effect; or
2. The spouse is ordered or required by the judgment, order, decree or settlement to pay an amount to the plan in connection with an ERISA fiduciary violation; or
3. The judgment, order, decree or settlement retains the spouse's right to receive the survivor annuity.

EXAMPLE 1-3. Offset of Account by Judgment for Fiduciary Breach. Monica is the owner of Company Y. For the last year, Monica has not transmitted to the plan the 401(k) contributions made by the Company Y employees. Both Company Y and Monica are now in bankruptcy. The contributions that have not been transmitted total $125,000. Monica's account balance in the 401(k) plan is $215,000. Monica's failure to transmit the 401(k) contributions on the participants' behalf is a breach of fiduciary duty. A judgment against Monica could be satisfied from her account balance.

If a participant is convicted of a crime, the sentence may not order payment of pension assets for restitution to the harmed party. [27] The offset described above may be used only if the crime is against the plan.

Bankruptcy Issues

A number of issues arise with respect to the protection of a participant's benefits in the event that the participant seeks bankruptcy protection. Many of these were affected in April 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).

ERISA plan interest is excludable from bankruptcy estate. Bankruptcy Code §541(c)(2) provides for the exclusion of trust property from the debtor's bankruptcy estate if that property contains a restriction on the transfer of a beneficial interest of the debtor that is enforceable under applicable nonbankruptcy law. The Supreme Court held in the *Patterson v. Shumate* case that the antiassignment provision in ERISA §206(d) is enforceable nonbankruptcy law which results in the exclusion of the plan benefit from the bankruptcy estate of the plan participant.[28] This ruling ended inconsistent application of the Bankruptcy Code to ERISA plans.

This position was confirmed by BAPCPA, which clarified and broadened the *Patterson v Shumate* case and later holdings to include both qualified plans and funded non-ERISA plans, such as 457

[27] *USA v. Jackson*, No. 99-50302 (9th Cir. October 12, 2000) (crime was for embezzlement of union assets).
[28] *Patterson v. Shumate*, 112 S.Ct. 2242 (1992).

plans, governmental plans and 403(b) programs. Furthermore, BAPCPA currently protects up to $1,243,025 in an Individual Retirement Account (IRA). The amount protected under BAPCPA is subject to cost-of-living adjustments. It is reviewed every three years and increased as needed. The limit on protection does not apply to funds rolled into an IRA from a qualified plan.

Other important BAPCPA provisions. BAPCPA also clarified that 401(k) elective contributions are protected from creditors, even if they have not yet been deposited to the plan. BAPCPA also gave participants a priority claim in bankruptcy to the employer's assets for undeposited elective contributions (up to certain maximums) that were due within 180 days of the bankruptcy filing. Finally, BAPCPA specifically permits a plan to continue to collect payments on participant loans from individuals who are in personal bankruptcy proceedings. This prevents the loans from going into default, which would likely result in increased income and excise tax liabilities for the participant. A recent Supreme Court case held that death benefits held in an inherited IRA for a beneficiary are not protected from the beneficiary's creditors in bankruptcy.[29]

IRC §401(a)(14) (Commencement of Benefits after Normal Retirement Age)

A qualified plan must not postpone the commencement of benefits later than the date provided in IRC §401(a)(14) without the employee's consent.

IRC §401(a)(15) (Social Security Increases)

A qualified plan may not reduce plan benefits due to increases in Social Security benefits that occur after plan benefit payments commence.

IRC §401(a)(16) (Annual Addition Limits)

A qualified plan must not exceed the limitations on contributions and benefits that are imposed by IRC §415.

IRC §401(a)(17) (Compensation Dollar Limit)

A qualified plan may not determine contributions or benefits by taking into account more than a prescribed dollar amount of compensation.

IRC §401(a)(19) (Withdrawal of Mandatory Contributions)

If a qualified plan provides for mandatory employee contributions, it may not forfeit benefits on account of a withdrawal of those contributions, except as permitted by IRC §401(a)(19).

IRC §401(a)(20) (Pension Plan Terminations)

A pension plan may permit a participant to receive distribution of benefits when the plan terminates, even though the normal distribution events permitted for pension plans are not satisfied by the participant.

IRC §401(a)(22) (Voting Rights on Employer Securities)

A defined contribution plan (other than a profit sharing plan) that invests in employer securities that are not readily tradable must satisfy the voting rights requirements of IRC §409(e) with respect to such securities. This requirement applies only if more than 10 percent of plan assets are in the form of employer securities.

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[29] *Clark v. Rameker*, 573 U.S. (2014).

IRC §401(a)(23) (Stock Bonus Plan Requirements)

If the qualified plan is a stock bonus plan, it must satisfy the requirements of IRC §409(h), relating to distributions in the form of employer securities and put options and the special distribution requirements of IRC §409(o).

IRC §401(a)(24) (Group Trust)

Some qualified plans commingle their respective assets into a group trust. IRC §401(a)(24) permits the inclusion in a group trust of the monies of any governmental plan, 457 plan or governmental unit described in IRC §818(a)(6).

IRC §401(a)(27) (Designation of Type of Defined Contribution Plan)

A profit sharing plan or money purchase plan must be designated as such.

IRC §401(a)(28) (ESOP Requirements)

A participant in an Employee Stock Ownership Plan (ESOP) who has attained age 55 and has at least ten years of participation in the plan must be permitted to diversify the investment of a portion of his or her account held in employer securities. Certain ESOPs must obtain independent appraisals of the employer securities.

IRC §401(a)(30) (Elective Deferral Limit)

A 401(k) plan must not permit elective deferrals for a calendar year to exceed the applicable dollar limit under IRC §402(g).

IRC §401(a)(31) (Direct Rollover)

A qualified plan must provide a direct rollover option for an eligible rollover distribution and must pay mandatory cashout amounts between $1,000 and $5,000 into a rollover IRA. However, a qualified plan is not required to accept rollover contributions.

Section 1.05: Plan Documents

ERISA and the IRC both require that qualified plans have written documents. The IRS has interpreted this requirement to mean that a plan document must be one integrated plan, containing all of the significant plan provisions, leaving only administrative details to the plan administrator's discretion. Certain IRC and Treasury Regulation rules must be fully included in the plan document; others may be incorporated by reference. Furthermore, the plan documentation may not include provisions that violate the law.

Historically, the IRS has published sample provisions that must be in a qualified plan document in the Listing of Required Modifications. This listing is modified when the law or guidance changes significantly, to reflect the then current rules. Beginning in 2005, the IRS established a new procedure for plan amendments and began providing a listing of the requirements for plan documents in an additional annual compendium, called the Cumulative List of Changes in Plan Qualification Requirements.[30]

INDIVIDUALLY DESIGNED PLANS

A plan sponsor may retain legal counsel or other practitioners to prepare a plan document from scratch, drafted particularly for that plan. This is called an **individually designed plan**. In reality, most attorneys or other practitioners

[30] Rev. Proc. 2005-66, 2005-37 I.R.B. 509, §4. See Notice 2015-84 for most recent Cumulative List of Changes.

maintain a sample plan document that contains the necessary language for a qualified plan and then modify that language as needed for a given client. Therefore, what really makes a plan individually designed is that the language has not been given pre-approval by the IRS and that each of these documents is reviewed in its entirety when a favorable determination letter is requested (see below).

PRE-APPROVED PLANS

As an alternative to an individually designed plan, a plan sponsor may elect to adopt a pre-aproved plan that is sponsored by an organization that provides services to the plan. A **pre-approved plan** is a document that has been pre-approved by the IRS for use for qualified plans. The document can be made up either in two parts, an adoption agreement and the basic plan document or as a single plan document. The adoption agreement contains the variable sections of the plan, with several options available to the adopting employer. The employer selects the desired provisions by checking boxes and filling in blanks on the adoption agreement. The basic plan document contains boilerplate language that is common to all plans of that type [i.e., 401(k), profit sharing, money purchase, defined benefit]. This part of the plan document may not be changed if the plan's pre-approved status is to be maintained. In the single document approach, the options not selected are deleted from the final document with only those selected remaining and looks like an individually designed plan.

Please note that prior to 2017, the IRS offered two separate programs. One was called the Master & Prototype (M & P) program and generally offered the plans in the two part format (basic plan document and adoption agreement). The other was referred to as the Volume Submitter Program which was generally made up of the one document format. Effective in 2017, the IRS combined the two programs under one title, call the Pre-Approved Program.

Sponsoring Organizations

An pre-approved plan may be maintained by any organization that expects to have at least 15 employer-clients adopt a basic plan document sponsored by that organization. Therefore, pre-approved plan sponsors are generally law firms, administration firms or fundholders that provide services to qualified plans. If the provider will be requesting more than one opinion letter it must certify that it will have at least 30 clients in aggregate.

Many pre-approved sponsors use one basic plan document for all the organization's defined contribution plans, with the differences between the types of defined contribution plans outlined in the adoption agreement or in language embedded in the basic plan document. The given basic plan document may have several different adoption agreements associated with it—such as a profit sharing adoption agreement, a 401(k) plan adoption agreement and a money purchase plan adoption agreement for a defined contribution plan.

An alternative to the two document approach is where the optional choices once made, are imbedded in the plan document and those not chosen are deleted by the document generation system. Prior to 2017, this format was known as the Volume Submitter program and the final document resembled an individually drafted document in appearance, yet was pre-approved.

A pre-approved document may also be provided by a mass submitter. A mass submitter is an organization that markets pre-approved documents to organizations that want to be sponsoring organizations of an pre-approved document, but do not want to design their own plans. Special qualifications and submission procedures apply to mass submitters. The sponsoring organization may either adopt the mass submitter's pre-approved documents on a word-for-word basis (known as the identical adopter of a mass submitter's plan) or it may make minor modifications of the mass submitter's document (known as a modified adopter of the mass submitter plan).

EXAMPLE 1-4. Mass Submitter. Detailed Document, Inc. is a mass submitter. They sponsor various pre-approved documents. For a fee, Detailed Document allows a XYZ Bank to become a sponsoring organization. XYZ Bank may now put their name on the pre-approved document and use it for their clients. XYZ Bank need not seek IRS approval for their documents. Instead, they can rely on the pre-approval received by Detailed Documents.

The sponsoring organization must maintain a list of employers that have used the pre-approved plan for their documents. Pre-approved sponsors must also make diligent efforts to ensure that adopting employers amend their plans when necessary. The IRS procedures also permit the sponsoring organization to amend the plan on behalf of the adopting employers when there is a legislative or other change in the law that requires a modification of the plan that is standard for all adopters.

IRS Approval of a Pre-approved Plan

The sponsoring organization (or, if applicable, the mass submitter) submits the pre-approved basic plan and adoption agreements (called the **lead documents**) to the IRS National Office for review. At the end of the process, if the IRS gives its approval to the lead documents, it will issue an **opinion letter** for each type of adoption agreement offered with the basic plan document.

Once the opinion letter is issued by the IRS, the plan documents may be used by employers. If the adoption agreement is completed correctly and no changes are made to the plan's boilerplate language, the adopting employer is able to rely on the IRS-issued opinion letter that the plan document meets all qualification requirements for a written plan.

FAVORABLE DETERMINATION LETTERS

No matter how competent and knowledgeable a practitioner is, he or she can never know for certain that an individually designed plan document satisfies all the qualification rules, or that there are not provisions in the plan to which the IRS would object on audit. Therefore, the IRS maintains a procedure whereby the practitioner may submit the plan document for a determination that it satisfies the qualification rules. The practitioner will submit the individually designed plan to the IRS. Effective in 2017, the IRS will only review plans for their initial qualification and upon the termination of the plan. The IRS reviews the document and, if there are objectionable provisions, give the practitioner an opportunity to modify the document as needed. Some negotiations may take place during this procedure, permitting the practitioner to discuss the provisions at issue with the IRS and come to an agreement about what any modified language should say.

At the end of the review and negotiation process, the IRS will issue a determination letter, stating whether the plan satisfies the qualification requirements. If it does, the letter is called a **favorable determination letter**. If the plan does not satisfy the qualification rules, the IRS will issue an adverse determination letter and will proceed with the steps to collect the taxes due on the basis that the plan has been disqualified. The plan sponsor may pay the taxes and concede the disqualification, pay the taxes and file a lawsuit in US District Court for a refund or refuse to pay the taxes and file a petition in Tax Court for adjudication of the disagreement.

A plan is never required to obtain a favorable determination letter and a plan may be a qualified plan without having such a letter. The letter is simply an advance determination by the IRS outside an audit setting that the plan document satisfies the qualification rules. Therefore, it is a matter of assuring the plan sponsor that this portion of the qualification rules is met. It is an almost universal practice to submit an individually designed plan for a determination letter.

Procedure for Submission of an Individually Designed Plan for Favorable Determination Letter

A determination letter may be requested on the initial plan, or upon the termation of the plan. The IRS maintains a procedure that is updated annually outlining what is needed for a determination letter submission. This procedure is Revenue Procedure XXXX-6, where the first four digits are the year the procedure was issued. For example, the Revenue Procedure for 2017 is Rev. Proc. 2017-6.

If the letter is requested on an individually designed plan, the submission is made with Form 5300. This form contains information about the plan sponsor, the plan being reviewed and other plans that the company maintains.

If the submitting individual is not the plan sponsor, a signed Power of Attorney (Form 2848) must be included. Only

attorneys, CPAs, enrolled agents, enrolled actuaries and enrolled retirement plan agents (ERPAs) may be designated as representatives under Form 2848. The IRS charges a user fee for the review of a plan for favorable determination.

If You're Curious . . .

The user fee for a favorable determination letter is currently $2,500 for an initial determination of an individually designed plan. The check for the user fee should be attached to a Form 8717 and included in the submission to the IRS. Revenue Procedure XXXX-8 (where the first four digits are the year of issuance) is updated annually to reflect current user fees.

Not less than ten nor more than 24 days prior to filing the determination letter application with the IRS, the plan sponsor must notify interested parties that the submission is being made.[31] This notice, the form of which is currently provided in Rev. Proc. 2017-6, advises these individuals that they may send comments to both the IRS and the DOL in relation to the determination letter application.[32] Interested parties include:

- All present employees who are eligible to participate in the plan; and
- Any present employees whose principal place of business is the same as those who participate in the plan.

If You're Curious . . .

If the plan covers 100 or fewer participants and at least one owner of more than 5 percent of the company, all employees are considered interested parties.[33] However, if the plan passes the ratio percentage test, only eligible employees are interested parties.[34] The notice to interested parties must be posted, mailed, hand delivered or provided by electronic delivery.

The submission should be sent to the IRS at the following address:

Internal Revenue Service
P.O. Box 12192
Covington, KY 41012-0192

If the IRS does not contact the plan sponsor or submitting practitioner within 270 days after the submission is made, a status conference with the IRS may be requested. The conference may take place in person or by telephone.[35]

As noted above, when the IRS does contact the submitting individual, it will discuss any issues that it finds in the application that it believes are problematic. The submitting individual generally will be given an opportunity to modify the document (through a remedial amendment) and the favorable determination letter will be issued contingent on the adoption of any proposed amendments by the plan sponsor. At the end of the process, the IRS will either issue the favorable determination letter or advise the submitter that it is proposing an adverse determination.

Updating Plans for Legislative and Regulatory Changes

At one time, plan sponsors commonly applied for determination letters in connection with any amendment of the plan for any reason. However, it became increasingly common for Congress to legislate significant modifications of the law relating to qualified plans. When these new laws were passed, it was necessary to amend plan documents—often through complete restatements—to con-

[31] Treas. Reg. §601.201(o)(3)(xv).
[32] Rev. Proc. 2016-6.
[33] Treas. Reg. §1.7476-1(b)(2).
[34] Treas. Reg. §1.7476-1(b)(6)(ii).
[35] Rev. Proc. 2016-6.

form to these changes. The IRS would establish a special remedial amendment period during which the plan would have to be updated to conform to these legislative changes. Any disqualifying provision would be corrected during this special period. Treasury Regulations give the IRS discretion to designate (usually through Revenue Rulings, notices or other guidance) a plan provision as a disqualifying provision if it:

- Results in the failure of the plan to satisfy the qualification requirements of the IRC because of a change made to such requirements; or
- Is integral to a qualification requirement of the IRC that has been changed.

A disqualifying provision also includes the absence from a plan of a provision that the new law or guidance requires or is integral to the new law, if the plan was in effect when the change became effective.[36]

During this remedial amendment period, the sponsor of an existing plan was granted extended reliance on the previously issued determination letter. This meant that the letter would continue to apply until the end of the remedial amendment period.[37]

Effect of Plan Termination

The remedial amendment period is accelerated for any law changes in effect as of the date that the plan is terminated. The plan must be updated to conform to the new law concurrently with the plan termination.[38]

The combination of amendment-induced favorable determination letter applications and the need to update plans to conform to the rash of legislative and regulatory changes made the entire process unwieldy, both for practitioners and the government reviewers. As a result, the Treasury altered the timing rules for amendments and favorable determination letter applications for both individually designed plans and preapproved documents.

Current Favorable Determination Letter Procedures

Under the rules in effect for 2017, each individually designed plan will be only be eligible to apply for a determination letter at the initiation of the plan and at the termination of the plan.

However, the plan document must be updated in the interim for any changes made in the law in relation to the qualification requirements. These changes will be published by the IRS as needed.

Revisions to Determination Letter Program

Effective January 1, 2017, the IRS eliminated the previous staggered 5-year determination letter remedial amendment cycles for individually designed plans. They will also limit the scope of the determination letter program for individually designed plans to initial plan qualification and qualification upon plan termination.[39]

Amending and Obtaining Favorable Opinion Letter on Pre-approved Plans

Under the current restatement procedure for preapproved plans, these documents must be amended for legislative and

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[36] Treas. Reg. §1.401(b)-1(b)(3).

[37] See, e.g., Rev. Proc. 89-9, 1989-1 CB 780, Rev. Proc. 89-13, 1989-1 801, Rev. Proc. 93-39, §13, 1993-2 C.B. 513, Rev. Proc. 2000-27.

[38] IRS Notice 87-57.

[39] Rev. Proc. 2016-37.

regulatory changes approximately every six years. All defined contribution preapproved plans are on one cycle, and all defined benefit preapproved plans are on a different cycle. The IRS publishes the due dates for the restatements as they arise.

Section 1.06: Department of Labor Considerations

PLAN ADMINISTRATOR

Title I of ERISA outlines, among other things, the parties who are responsible for making sure the plan operates correctly. These parties are generally called fiduciaries. One of these fiduciaries, the plan administrator, is the person designated to be responsible for the administration and operation of the plan. The plan administrator must be identified in the plan document.[40]

If You're Curious . . .

The plan may designate the plan administrator:

- By name;
- By reference to the person or group of persons holding the position (e.g., the employer);
- By reference to a procedure under which the administrator is designated (e.g., a committee appointed by the board of directors); or
- By reference to a person or group of persons charged with the specific responsibilities of a plan administrator.[41]

If a plan administrator is not designated by the plan, the plan sponsor is the plan administrator.[42] If a plan sponsor cannot be determined, the plan administrator is the person or persons actually responsible for the control, disposition or management of the cash or property received by or contributed to the plan.[43]

Notwithstanding the fact that they are often referred to colloquially as plan administrators, third party administrators (TPAs) and other service providers rarely fulfill that role under ERISA. TPAs generally perform only ministerial functions for the plan or functions that are authorized by the plan sponsor or other responsible party, and do not have or exercise any discretion in the management of the plan. However, it is becoming increasingly common for TPAs to accept the delegation of some of the fiduciary duties normally assigned to the named plan administrator.

If You're Curious . . .

WRITTEN TRUST REQUIREMENT

A qualified plan generally must be funded with a trust.[44] A qualified trust is exempt from federal income tax under IRC §501(a), subject to exceptions for unrelated business taxable income. A trust document includes the governing provisions of the trust. The trust document may be set forth in a separate document, apart from the plan document, or may be incorporated into the plan document. When the trust document is incorporated into the plan document, the trust provisions will typically be one of the articles or sections of the plan document and the trustee will execute the plan and trust document with the plan sponsor.

[40] ERISA §3(16)(A)(i) and IRC §414(g)(1).
[41] Treas. Reg. §1.414(g)-1(a).
[42] ERISA §3(16)(A)(i) and IRC §414(g)(1).
[43] Treas. Reg. §1.414(g)-1(b)(4).
[44] ERISA §403.

Alternatives to Trust

Nontrusteed Plan (Fully Insured)

A qualified plan may be funded solely with annuity and insurance contracts. The employer may hold these contracts for the benefit of the employees without establishing a trust.[45] A fully insured qualified plan that is nontrusteed is sometimes known as a qualified annuity plan.[46] For qualified plan purposes, the employer is treated as the trustee because it holds the contracts that fund the plan.[47]

Custodial Account

A custodial account may be used to hold the assets of the plan, instead of a trust, provided the custodian is a bank.[48] A bank is defined as a financial institution that satisfies the definition of a bank in IRC §581, an insured credit union or a corporation which, under state law, is subject to supervision and examination by the Commissioner of Banking or other state officer in charge of the administration of the state's banking laws.[49]

Domestic Trust

IRC §401(a) requires that the trust be created or organized in the United States (i.e., a domestic trust).[50]

Effect on Plan Qualification

Treas. Reg. §1.401-1(a)(3)(I) requires that a trust forming part of a qualified plan be created or organized in the United States, and be maintained at all times as a domestic trust. Failure to qualify as a domestic trust would cause the trust to lose its tax exemption under IRC §501(a).

Special Rule for Puerto Rican Trusts

ERISA §1022(i)(2) and Treas. Reg. §1.401(a)-50 permit an administrator of a trust created or organized in Puerto Rico to elect to have the trust treated as a US trust for purposes of the qualified plan rules under IRC §401(a). This election is not restricted to trusts that are domestic trusts under IRC §7701(a)(30), so the conditions outlined in IRC §7701(a)(30) are not applicable to Puerto Rican trusts electing tax exemption.

Trustee

The trustee is the person named in the trust or who is appointed as trustee by a named fiduciary . The trustee has exclusive authority and discretion to manage and control the assets of the plan, unless the trustee is subject to the investment directions of a named fiduciary, an investment manager or the plan participants.[51]

Application of State Law

Neither the IRC nor ERISA defines the trustee of an employee benefit plan. The IRS, however, has

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[45] Treas. Reg. §1.401-9, ERISA §403(b)(1).
[46] IRC §403(a).
[47] IRC §401(f).
[48] IRC §401(f)(2), ERISA §403(b)(3).
[49] IRC §408(n).
[50] Treas. Reg. §301.7701-5 and §301.7701-7, 64 F.R. 4967 (February 2, 1999) and 6 F.R. 41778 (August 9, 2001).
[51] ERISA §§403(a) and 404(c).

said that state law controls whether a valid trust is established, except to the extent federal law specifically supersedes the state law. [52]Thus, the person named as the trustee in the trust instrument, or who is designated as the trustee by persons authorized to appoint a trustee under the trust instrument, must be named or appointed in accordance with state law. ERISA §405(c)(3) also defines trustee responsibility to mean any responsibility provided in the trust instrument to manage or control the assets of the plan.

NOTIFICATION TO PARTICIPANTS: SPDS AND SMMS

Title I requires that participants be provided with information that advises them regarding the terms of the plan and the participants' enforcement rights under ERISA. The primary tools for providing this information are the summary plan description (SPD) and the summary of material modifications (SMM).

Summary Plan Description

The **summary plan description** (SPD) is the primary disclosure document required by Title I of ERISA. Through the SPD, the participants and beneficiaries are given information about the material provisions of the plan, how they make a claim for benefits and what their rights are under ERISA. The plan administrator is required to furnish the SPD to each participant covered under the plan and to each beneficiary receiving benefits under the plan.[53]

Content and Style of the SPD

ERISA and DOL regulations outline the information that must be included in the SPD and the manner in which it must be presented.

The SPD must be written in a manner that is reasonably expected to be understood by the average plan participant.[54] The plan administrator must consider the level of comprehension and education of the typical plan participants and the complexity of the terms of the plan. Technical jargon and long, complex sentences should not be used. The DOL encourages the use of examples and illustrations to explain the terms of the plan, clear cross-references and a table of contents. The DOL is especially concerned that any limitations, reductions or restrictions on plan benefits are described in no less prominent style than that used to describe the plan benefits.

If You're Curious . . .

Foreign language requirements. If a substantial number of participants are literate only in a particular non-English language, a notice written in that language must be included in the SPD that offers assistance in understanding the SPD. Alternatively, the plan administrator must provide an SPD that is translated into that language.

The notice must be provided to a plan with fewer than 100 participants at the beginning of the plan year only when 25 percent or more of the participants are literate only in the same non-English language. In a larger plan (i.e., 100 or more participants), the notice is required whenever the number of participants that are literate only in the same non-English language is at least equal to the lesser of 10 percent of the participants or 500 participants.[55]

Content of the SPD. The information that must be included in the SPD includes:[56]

[52] Rev. Rul. 81-114, 1981-1 CB 207 (January 1, 1981).
[53] ERISA §101(a).
[54] DOL Reg. §2520.102-2.
[55] DOL Reg. §2520.102-2(c).
[56] DOL Reg. §2520.102-3.

- Identifying information about the plan, the employer and the fiduciaries;
- The requirements for eligibility;
- How benefits accrue;
- Vesting requirements;
- When distributions are available;
- The forms of payment available;
- How to make a claim for benefits;
- Description of the circumstances which may result in disqualification, ineligibility or denial;
- A clear explanation of a participant's enforcement rights under ERISA (a sample of which is provided by the DOL in the regulation);[57]
- If the plan is intended to be covered by ERISA §404(c), a statement that it is "an ERISA section 404(c) plan";
- A description of the plan's QDRO procedures or a statement that participants and beneficiaries may receive them without charge from the plan administrator; and
- Details regarding the effect of a plan termination on a participant's rights under the plan.

The regulation provides for simplified content requirements for retired participants, separated participants with vested benefits and beneficiaries receiving benefits from the plan.[58]

If You're Curious . . .

Different SPDs for different classes of participants. Sometimes a plan provides for different benefits or different plan features for different classes of participants and beneficiaries. In such a case, a separate SPD may be prepared for each class.[59] Each SPD may omit information that is not applicable to the class of participants and beneficiaries to which it is furnished. The first page of the SPD must describe the class of participants and beneficiaries to which it applies and also must list the other classes covered by the plan. An employer may want to take advantage of this rule where the plan provides for different levels of contributions or benefits, depending on an employee's job classification.

When to Provide the SPD

Participants. A participant must receive the SPD by not later than 90 days after he or she first becomes a participant.[60] If the plan is a new plan, the 90-day deadline is extended so that the SPD must be provided by not later than 120 days after the later of the effective date or the adoption date of the plan.[61]

If a participant quits or is otherwise terminated and later is rehired by the employer, the plan is not automatically required to furnish an SPD to the employee. However, this rule depends on the participant's status as a result of the termination of employment. If the individual was paid his or her entire vested benefit during the period of termination, that individual is treated as a new participant when he or she recommences participation, and the SPD must be provided. Conversely, if any portion of the vested benefit remains undistributed as of the rehire date, no SPD needs to be furnished.[62]

Beneficiaries. A beneficiary is not required to receive an SPD until 90 days after he or she begins to receive benefits from the plan. The beneficiary is not considered to have an enforceable interest in the plan until an event occurs that entitles the beneficiary to receive benefits, so there is no need to provide the SPD earlier. If there is a QDRO, the alternate payee is considered to be the beneficiary.

[57] DOL Reg. §2520.102-3(t).
[58] DOL Reg. §2520.104b-4.
[59] DOL Reg.§2520.102-4.
[60] ERISA §104(b)(1).
[61] *Id.*
[62] DOL Reg. §2510.3-3(d)(2)(ii).

Updating the SPD. Every fifth year, the SPD must be updated, unless there have been no amendments made to the plan during that period that would affect the SPD's contents. Every tenth year, the SPD must be updated, regardless of whether amendments have been made. An updated SPD must be provided to participants and to beneficiaries receiving benefits by not later than 210 days following the close of the plan year for which the SPD is updated.[63] The latest SPD and required summaries of material modification (see below) must be provided to the beneficiaries, retired participants and separated participants, along with a statement of their benefit rights and the right to receive the updated SPD upon request.

Enforcement of the SPD Requirement

The primary means of enforcement of the disclosure rules include audit, court enforcement and criminal penalties.

If You're Curious . . .

Audit. The DOL conducts periodic audits of plans to ensure compliance with the disclosure rules. If an SPD has not been prepared, the DOL will advise the plan administrator to do so and distribute the SPD, or it will seek legal remedy. The DOL also may request a copy of the SPD and a $100 per day ($1,000 maximum) penalty applies to a failure to produce such document within 30 days of the request.[64] The DOL may use this right as a means of enforcing the disclosure requirements.

Court enforcement. The DOL has the power to enforce the provisions of ERISA in the federal courts.[65] In the case of a plan's failure to provide the SPD, the DOL may seek an injunction under which the court orders the plan administrator to prepare the SPD or risk contempt proceedings. The DOL also may seek "other equitable relief" that might be appropriate to redress any harm resulting from the failure to comply with the SPD requirements.

Criminal penalties. ERISA authorizes the criminal prosecution of any person who willfully violates the disclosure requirements. Conviction may result in a fine of not more than $5,000 or imprisonment for not more than one year. If the culpable person is not an individual (e.g., a corporation), the maximum fine is $100,000.[66]

Participant action to enforce SPD requirements. A participant or beneficiary may bring suit to enforce the provisions of ERISA, just like the DOL.[67]

Conflicts Between the Plan and the SPD

Suppose the terms of the plan conflict with the description in the SPD. Which controls? While many courts took the position over the years that the SPD would control, particularly when its terms were more favorable to participants,[68] the Supreme Court has made it clear that the plan document con-

[63] ERISA §104(b); DOL Reg. §2520.104b-2(b).
[64] ERISA §§104(a)(6), 502(c)(6).
[65] ERISA §502.
[66] ERISA §501.
[67] ERISA §502(a)(3).
[68] See, e.g., *Aiken v. Policy Management Systems Corp*., 13 F.3d 138 (4th Cir. 1993) (more favorable provisions of SPD will control if participant shows detrimental reliance or prejudice); *Bergt v. Retirement Plan for Pilots Employed by MarkAir, Inc*., 28 EBC 1398 (9th Cir. 2002) (conflict between SPD and plan resolved in light most favorable to employee); *Burke v. Kodak Retirement Income Plan*, 30 EBC 2345 (2nd Cir. 2003) (requirement for domestic partner to file affidavit to obtain rights to spousal income benefit was omitted from SPD; granted spousal benefit due to harm caused by SPD omission); *Burstein v. Retirement Account Plan for Employee of Allegheny Health Education and Research Foundation*, 30 EBC 2121 (3rd Cir. 2003); *Edwards v. State Farm Mutual Auto Insurance Co.,* 851 F.2d 134 (6th Cir. 1988); *Hanson v. Continental Insurance Co*., 940 F.2d 971 (5th Cir. 1991); *Helwig v. Kelsey-Hayes Co*., 93 F.3d 243 (6th Cir. 1996); *Henne v. Allis-Chalmers Corp.,* 660 F.Supp 1464 (E.D. Wisc. 1987); *Kreutzer v. A.O. Smith Corp.,* 951 f.2d 739 (7th Cir. 1991); *Washington v. Murphy Oil, Inc.,* 2007 WL 2326071 (No. 05-31063)(5th Cir. 2007), where a direct conflict between the SPD and the plan was resolved in favor of the participant without requiring a showing of reliance by the participant on the SPD.

trols.[69] There is some possibility that a participant who shows that he or she reasonably relied on the SPD and suffered a significant detriment as a result of that reliance may be able to bring and win a lawsuit against the plan, but this would be a difficult row to hoe.

Summary of Material Modification

A summary of material modifications (SMM) is required when there has been a material modification to the plan or when the information provided in the summary plan description (SPD) has changed. The summary must explain the amendment or change in a manner that can be reasonably understood by the average participant.

Timing of SMM Distribution

The plan administrator must provide a copy of the SMM to each participant and each beneficiary who is receiving benefits under the plan by not later than 210 days after the close of the plan year in which the amendment was adopted.[70] Note that this means that the date of adoption for an amendment that has an effective date that is retroactive to an earlier year will control the due date of the SMM, not the effective date of the amendment.

If a participant or beneficiary is receiving the SPD for the first time, any previously prepared SMMs that describe amendments that have not yet been incorporated into the SPD should accompany that SPD. No SMM is required if the change is incorporated into an SPD that is delivered to participants prior to the deadline of the SMM.

What Is a Material Modification?

The regulations do not describe what amendments or changes are considered material. Common sense should prevail here. If in doubt, the plan administrator should err on the side of disclosure. Examples of changed provisions that should be disclosed in an SMM include:

(a) Eligibility and/or vesting provisions;
(b) Allocation or benefit formula;
(c) Conditions for accruing benefits or receiving an allocation;
(d) Distribution options;
(e) New trustees, plan administrator, employer sponsor or other named fiduciary;
(f) Participant loan program;
(g) Adoption of a 401(k) arrangement or an after-tax employee contribution feature;
(h) Adoption of a participant-directed investment option; or
(i) Benefit claims procedures.

SMMs do not have to be provided to retired participants, beneficiaries receiving benefits or vested separated participants if the modification in no way affects such person's rights under the plan.[71]

Enforcement of SMM Requirements

ERISA does not impose civil penalties on a plan administrator for failure to comply with the SMM requirement. The DOL may request a copy of the SMM and a $100 per day penalty ($1,000 maximum) applies to a failure to produce such document within 30 days of the request.[72]

[69] *CIGNA v. Amara*, 131 S.Ct. 2900 (2011).
[70] DOL Reg. §2520.104b-3(a).
[71] DOL Reg. §2520.104b-4(c).
[72] ERISA §§104(a)(6) and 502(c)(6).

Section 1.07: Tax Consequences of Plan Disqualification

In this section, we'll review the tax ramifications of plan disqualification. These tax ramifications will affect tax years that include the first year in which the disqualification is effective and all subsequent years. However, tax years that are closed for tax purposes cannot be reopened by the IRS. A **closed year** is one for which the statute of limitations on the collection of tax has ended. The timing of the statute of limitations depends on the return involved and the type of tax that the IRS is attempting to collect.

In reality, it is very rare for a plan to be disqualified. Customarily, if a plan is audited and the IRS discovers a qualification failure, the plan sponsor will enter into a negotiated settlement with the IRS under the procedures contained in the Employee Plans Compliance Resolution System (EPCRS) established by the IRS.[73] These are discussed below. However, the ramifications of disqualification remain relevant even for plans that enter into an EPCRS settlement. In an audit setting, the plan sponsor will be required to pay a monetary sanction as part of the settlement, and the starting point for negotiating the amount of that sanction is the amount of taxes that would have been due had the plan been disqualified (called the "maximum payment amount" in the EPCRS procedure).

DISALLOWANCE OF EMPLOYER'S DEDUCTION

If the plan is disqualified, the employer loses its deduction for nonvested contributions made to the plan for open tax years.[74]

Statute of Limitations

An employer's tax years generally are open for three years from the due date (including extensions) of the employer's tax return. For example, if a corporation's 2017 tax year ended December 31, 2017, the 2017 year is open until March 15, 2021 (i.e., three years after the March 15, 2018, due date for the return), assuming the return was not on extension.

A six-year statute can apply if there is a substantial under-reporting of income. No statute of limitations applies if a return was not filed for the year, or if a fraudulent return is filed.

Loss of Deduction

If a plan does not maintain separate shares for each employee (e.g., a defined benefit plan with more than one participant), the entire deduction is lost, even if the contributions fund vested benefits.[75]

Deduction of Contributions That Become Vested in Later Years

If a plan remains disqualified, a contribution (or portion of a contribution) that is not deductible because it was not vested when contributed, will be deductible in the later year in which it becomes vested.[76]

For example, suppose that a plan is audited and found to be disqualified for the 2017 plan year. A contribution was made on John's behalf in the amount of $10,000. John is zero percent vested in 2017, so the plan sponsor's deduction for that contribution is disallowed on audit. In 2019, John becomes fully vested in the $10,000. At that time, the plan sponsor may deduct the $10,000 amount.

EMPLOYEE'S INCOME

For open tax years, the employee recognizes income with respect to the vested contributions (or funding attributable to

[73] Rev. Proc. 2013-12, 2013-4 I.R.B. 313 (Dec. 31, 2012).
[74] IRC §404(a)(5).
[75] Treas. Reg. §1.404(a)-12(b)(3).
[76] Treas. Reg. §1.404(a)-12(b)(1).

vested benefits accrued under a defined benefit plan).[77]

Statute of Limitations

An employee's tax years generally are open for IRS audit for three years from the due date (including extensions) of his or her personal income tax return (i.e., Form 1040). For example, the 2017 tax year is open until April 15, 2021 (i.e., three years after the April 15, 2018, due date for the return), assuming the return was not on extension. A six-year statute can apply if there is a substantial under-reporting of income. No statute of limitations applies if a return was not filed for the year or if a fraudulent return is filed.

Special Rules if Coverage Failed

If the plan failed coverage under IRC §410(b) and the failure was not cured in a timely fashion under Treas. Reg. §1.401(a)(4)-11(g) (i.e., within 9½ months after the close of the plan year) nor under the IRS's correction procedures, the HCEs are taxed on their entire vested account balance (or present value of vested accrued benefit, in case of a defined benefit plan).[78]

If the plan is disqualified solely because of a coverage violation, nonhighly compensated employees (NHCEs) do not recognize income because of the disqualification, even with respect to vested contributions allocated with respect to such employees.[79]

Nonvested Contributions

If a contribution (or portion of a contribution) is not includible in income because it was not vested when contributed, the nonincludible amount (as adjusted for gains and losses) is includible in income in the year it becomes vested.[80] In the above example, John would be taxed on $10,000 in 2019, when he vested in the account.

TRUST INCOME

If the plan is disqualified, the trust loses its tax exemption. Therefore, for open tax years, the trust must recognize income attributable to current earnings (e.g., interest, dividends, and capital gains).[81]

Statute of Limitations

The statute of limitations on trust income is three years from the date on which the Form 5500 is filed.

DISTRIBUTIONS IN NONQUALIFIED YEARS

A distribution from a disqualified plan is not eligible for rollover. Any amounts rolled over to an eligible retirement plan [as defined in IRC §402(c)(8)] would not be excludable from income because of such rollover. The distribution would be includible in income in the year of payment, as if the rollover did not occur.

Excise Taxes on Recipient IRA

If the rollover was made to an IRA, excise taxes under IRC §4973 may apply if the bad rollover results in excess contributions to the IRA.

[77] IRC §402(b).
[78] IRC §402(b)(4).
[79] IRC §402(b)(4)(B).
[80] Treas. Reg. §1.402(b)-1(b)(3) and (4).
[81] IRC §501(a) and Rev. Rul. 74-299.

Protection of Recipient Plan's Qualification

If the rollover was to another qualified plan, that other plan's qualification is protected if it was reasonable to assume the distributing plan was qualified when the rollover was made.[82]

CLOSED TAX YEARS

If the disqualification of the plan reaches back to tax years that are closed, the IRS will not be able to collect the applicable taxes for those years. However, the disqualification of the plan continues until the disqualifying failure is corrected. The IRS takes the position that, if a disqualifying failure occurs, the disqualification taints all future plan years until the failure is corrected. This is true even if the failure arose in a year for which the statute of limitations for collecting taxes has closed.[83] The IRS may require correction of failures as a condition to requalify the plan, even if the correction affects years that are closed for tax purposes. An employer must be willing to correct all errors, even those in closed tax years, to participate in the IRS's correction programs under EPCRS (discussed below).

Section 1.08: Correction of Disqualifying Failures (EPCRS)

Because of the significant ramifications of plan disqualification, it is in the best interests of plan sponsors, participants and beneficiaries for qualified plans to retain their qualified status. Furthermore, the IRS wants to make sure that plans that are administered responsibly are able to remain qualified. Notwithstanding everyone's best intentions, the breadth of the requirements for plan qualification is so large, it is not uncommon for an error to be made that threatens a plan's qualified status.

The IRS could ensure that every plan complies with the law by auditing each plan. This is not a practical alternative. In fact, fewer than 5 percent of the plans in the country are audited each year. Therefore, the IRS must actively encourage plan sponsors and administrators to voluntarily keep their plans in compliance.

The combination of the need to encourage compliance and the relative likelihood of error led to the creation by the IRS of a program under which compliance problems may be corrected and a plan's qualified status preserved. The program is called the **Employee Plans Compliance Resolution System** (EPCRS). The terms of the program are outlined in an IRS procedure that is periodically updated. The most recent procedure is Rev. Proc. 2016-51.[84]

TYPES OF DISQUALIFYING FAILURES

There are four types of situations that can cause a plan to be disqualified.

Plan Document Failure

ERISA and the IRC both require that a plan be a written document. The IRS has interpreted this rule to require that certain provisions be clearly stated in the written document. These provisions include the material terms of the plan (e.g., eligibility requirements, benefit formulas, vesting formulas), as well as certain legal requirements [e.g., IRC §415 limitations, IRC §401(a)(17) limitation on compensation used, IRC §401(a)(4) nondiscrimination requirements]. If the plan document fails to have the required provisions, the IRS will find that the document is insufficient for the written plan requirement, and the plan may be disqualified.

Similarly, a document is not permitted to contain provisions that, on their face, violate the qualification requirements. For example, a 401(k) plan could not contain a provision that divested participants of their elective contributions under

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[82] Treas. Reg. §1.401(a)(31)-1, Q&A-14.

[83] *Martin Fireproofing Profit Sharing Plan v. Commissioner*, 92 T.C. 1173 (1989).

[84] Rev. Proc. 2016-51 2013-4 I.R.B. 313 (Dec. 31, 2012).

any circumstances, even if that provision was never actually followed in practice.

The failure to include required provisions, or the inclusion of a provision that violates the qualification rules, is called a **plan document failure**.[85] As previously discussed, new legislation commonly changes the documentation requirements for qualified plans. One of the more common ways for a document failure to occur is for a sponsor to fail to amend a plan on a timely basis for legislative changes. Plans that experience this type of failure are often called **nonamenders**.

Sometimes, if a plan is audited or the employer has submitted the plan for a favorable determination letter, the employer is asked to produce prior documentation. On occasion, the plan sponsor is not able to locate these documents, due to a fire or other casualty or simply because the document is lost. Because plan sponsors are required to maintain plan records, an inability to produce copies of plan documentation can be tantamount to a failure to amend a plan, which will be a plan document failure.

Operational Failure

Because a plan must be in writing, it stands to reason that the document provisions should control the actual operations of the plan. As a result, the IRS has deemed a failure to follow the terms of the plan to be a disqualifying failure. Because this failure is a result, not of the document, but of the practices followed by the plan, it is an **operational failure**.[86]

It is not important that the plan operations did not violate the technical provisions of the IRC. The fact that the operations did not comply with the plan document is the basis of the disqualification.

EXAMPLE 1-5. Operational Failure. The ABC Profit Sharing Plan document provides that participants' accounts will be subject to five-year graded vesting (that is, vesting at the rate of 20 percent per year of service, with full vesting in that fifth year). It is permissible under the IRC for the plan to provide for three-year cliff vesting (no vesting until the completion of three years of service, and then full vesting). ABC, the plan sponsor and administrator, decides to vest the participants under the three-year cliff schedule, but fails to amend the plan. When participants' accounts under the plan are forfeited based on the three-year cliff vesting schedule, the ABC Plan has caused an operational failure to occur.

Demographic Failure

Coverage under IRC §410(b), participation in defined benefit plans under IRC §401(a)(26) and nondiscrimination under IRC §401(a)(4) are requirements that are dependent on the demographics of the plan population. If a sufficient number of NHCEs benefit under the plan, coverage and participation rules will be met. If the contributions or benefit accruals occur for a broad enough cross-section of participants, the plan will not be discriminatory.

Sometimes a plan operates completely according to its terms and is written properly, but the demographics of the employee group are such that one or more of these rules is failed. Because a plan is required to satisfy coverage, participation and nondiscrimination requirements, when a plan does not, there is a disqualifying **demographic failure**.[87]

Employer Eligibility Failure

Governmental employers are not permitted to sponsor 401(k) plans. Only companies exempt from taxes under IRC §501(c)(3) and public schools may sponsor a 403(b) plan. If a company that is not legally permitted to sponsor one of these plans does so anyway, the result is an **employer eligibility failure**.[88] Unlike the other types of failures, this type of failure cannot be fixed in such a way as to qualify the plan. The goal of EPCRS in this situation is to get the employer

[85] Rev. Proc. 201-51, §5.01(2)(a).
[86] Rev. Proc. 2016-51, §5.01(2)(b).
[87] Rev. Proc. 2016-51, §5.01(2)(c).
[88] Rev. Proc. 2016-51, §5.01(2)(d).

and the plan participants out of the illegal plan in the least disruptive manner possible.

ISSUES THAT CANNOT BE RESOLVED THROUGH EPCRS

EPCRS is only for resolution of qualification failures, as described above. There are, of course, other types of actions that have tax or penalty consequences under the IRC, which are not resolvable under EPCRS.[89] However, there are certain exceptions to this general rule that may apply if the failures are submitted to the IRS for review under EPCRS.

Late Filing of Form 5500 Series Return

Penalties are imposed under IRC §6652 and ERISA §502(c)(2) for late filing of a Form 5500 series return. If the IRS or DOL issues a penalty notice on a late return, the taxpayer must negotiate for a reduction or waiver of the penalty. EPCRS is not available for this negotiation.

The DOL, however, has a program called the **Delinquent Filer Voluntary Compliance (DFVC) Program**, under which reduced penalties for late filings are available. Participation in the DFVC Program also results in a waiver of applicable penalties by the IRS, without having to submit a reasonable cause waiver request.

Late filed Forms 5500-EZ are not correctable under DFVC, because they are not filed with the DOL. However, the IRS established a separate program for late Forms 5500-EZ and similar filings by sponsors of plans that are exempt from Title I of ERISA. The program, established under Rev. Proc. 2015-32, provides reduced penalties for late filings.[90]

Prohibited Transaction Excise Taxes

If the plan engages in a prohibited transaction, excise taxes are imposed under IRC §4975 on the disqualified person who engaged in the transaction with the plan. EPCRS is not available to obtain a reduction or waiver of these taxes.

Title I Liability

Title I of ERISA protects the benefits of plan participants and beneficiaries. Any resolution of qualification failures through EPCRS will not protect the plan sponsor or the plan fiduciaries from any potential liability under Title I of ERISA. However, a fiduciary may receive a no-action letter from the DOL and relief from the ERISA §502(l) civil penalty for certain breaches that are resolved through the DOL's **Voluntary Fiduciary Correction Program (VFCP)**.

EPCRS Generally Does Not Waive Applicable Taxes on Corrective Action

When a qualification failure is corrected under EPCRS, any income taxes that are applicable to the corrective action are not waived.[91] For example, if the corrective action is a distribution, that distribution is includible in income, except to the extent it represents a return of previously taxed amounts (i.e., basis).

In some circumstances, however, if an excise tax applies, EPCRS may assist the taxpayer in obtaining a waiver of that excise tax. For example, if the qualification failure is a failure to make timely minimum distributions under IRC §401(a)(9), the excise tax imposed by IRC §4974 is still applicable, unless the plan sponsor specifically requests that the IRS waive the tax in the EPCRS process.[92]

Similarly, a plan sponsor may request that the excise taxes on nondeductible contributions under IRC §4972 and on excess contributions and excess aggregate contributions under §4979 be waived in the EPCRS process.[93] In certain

[89] Rev. Proc. 2016-51, §6.09.
[90] Rev. Proc. 2016-51.
[91] Rev. Proc. 2016-51, §6.09.
[92] Rev. Proc. 2016-51, §6.09(2).
[93] Rev. Proc. 2016-51, §6.09.

circumstances, the employer may request that the IRS waive income and excise tax ramifications of a participant loan that does not with IRC §72(p).

It may be possible to obtain IRS assistance in resolving tax-related penalties that cannot be handled under EPCRS under a closing agreement program. Practitioners should consider this option for tax issues that arise.[94]

Correction of Terminated Plans

A terminated plan may correct qualification failures through EPCRS, even if the trust is no longer in existence.[95] If the trust's assets have already been distributed from the terminated plan, the correction of a qualification failure might require the funding of additional amounts that will resurrect the trust. This could result in additional Form 5500 filings.

If operational failures are to be corrected after the distribution of the assets of a terminated plan, it is recommended that the employer not rely on the self-correction procedures discussed below, but instead make formal application to the IRS through the voluntary correction procedure. A qualification failure with respect to a terminated plan might be a plan document failure (e.g., a terminated plan was not amended for EGTRRA and was distributed without first obtaining a determination letter) or a demographic failure (e.g., a coverage failure that was not corrected before the plan was fully distributed), necessitating the adoption of plan amendments as part of the corrective action, in addition to any benefit restoration that might be necessary.

If You're Curious . . .

Correction of Orphan Plans

A plan for which the plan sponsor no longer exists, cannot be located or is unable to maintain the plan is called an orphan plan. EPCRS permits an orphan plan that has qualification failures to be corrected by certain "eligible parties."[96] Eligible parties include:

- a court-appointed representative with authority to terminate the plan and dispose of the assets;
- in the case of a plan under investigation by the DOL, a person or entity who the DOL determined has accepted responsibility for terminating the plan and distributing the plan's assets; or
- for a plan that has never been subject to Title I of ERISA, a surviving spouse who is the sole beneficiary of a plan that provided benefits only to the sole owner of the business that sponsored the plan.[97]

EPCRS CORRECTION PROGRAMS

Under EPCRS, there are three methods by which errors may be corrected:

- The Self-Correction Program (SCP);
- The Voluntary Correction with IRS Approval Program (VCP); and
- The Audit Closing Agreement Program (Audit CAP).

Under each of these programs, the plan sponsor agrees to make correction of the error and the IRS agrees not to disqualify the plan because of the error.

[94] Delegation Order 8-3, see, Internal Revenue Manual 1.2.47; IRS Employee Plans News Issue 2013-10 (12/19/13).
[95] Rev. Proc. 2016-51, §4.07.
[96] Rev. Proc. 2016-51, §4.09.
[97] Rev. Proc. 2016-51, §5.03(2).

SELF-CORRECTION PROGRAM (SCP)

The **Self-Correction Program** (SCP) is a self-initiated correction program for resolving operational failures.[98] It involves no disclosure or fees to the IRS. SCP really is the formalization of what many plan sponsors and plan administrators would do anyway—fix a problem when one is discovered. However, by formalizing the program, the IRS is also saying that, if the eligibility requirements for SCP are not satisfied, the plan sponsor proceeds at its own risk, even if the operational failure is corrected.

Significant and Insignificant Violations

Voluntary use of SCP can resolve significant violations and insignificant violations. SCP is also available for resolving insignificant operational failures that are discovered in an audit [i.e., Audit CAP (defined below) may be avoided if insignificant errors are discovered and corrected during the IRS's examination of the plan].[99]

Two-Year Correction Period for Correcting Significant Violations Under SCP

Why is it necessary to determine whether an operational failure is a significant or insignificant violation? The main reason is that voluntary correction under SCP is available for only a limited period of time to fix a significant violation. Except as provided below, that period is two plan years following the plan year in which the operational failure occurred.[100] For example, if a plan violates the IRC §415 limits in a plan year ending December 31, 2017, the self-correction period for significant violations normally would end on December 31, 2019. If the two-year correction period has not expired, there is no need to determine whether the operational failure is significant or insignificant.

Exception to the two-year correction period is made for correction of ADP/ACP tests and for significant failures related to plan asset transfers or plan assumption due to a corporate merger, acquisition or similar business transaction. These exceptions are discussed below.

Special rule for determining two-year period for SCP correction of the ADP test and ACP test. The two-year period for correcting an ADP test violation or an ACP test violation begins after the close of the 12-month correction period that is provided by the regulations under IRC §§401(k) and 401(m).[101] For example, suppose a 401(k) plan fails the ADP test for the plan year ending December 31, 2017. The regulatory correction period ends December 31, 2018. The SCP self-correction period would run for two plan years beyond that (i.e., January 1, 2019, through December 31, 2020).

If You're Curious . . .

Special rule for business mergers, acquisitions, etc. If a significant failure relates to transferred assets from another plan or the assumption of a plan due to a corporate merger, acquisition or similar business transaction, SCP allows such failure to be corrected up to the last day of the plan year that begins after the year in which the corporate merger, acquisition, or similar business transaction occurred, even if the failure occurred more than two plan years earlier (i.e., prior to the employer transaction).[102]

EXAMPLE 1-6. Special Correction Period for Plan Acquired in Business Transaction. In 2018, Company X purchased the assets of Company Y. As part of the purchase, the Y plan was merged into the X plan. The plan year for the X plan ends December 31. During early 2019, in a compliance review conducted with respect to the transferred assets, Company X determines that

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[98] Rev. Proc. 2016-51, Part IV.
[99] Rev. Proc. 2016-51, §8.01.
[100] Rev. Proc. 2016-51, §9.02(1).
[101] *Id.*
[102] Rev. Proc. 2016-51, §9.02(2).

there are some uncorrected IRC §415 violations dating from 2009 in the former plan Y accounting. Assuming Company X is otherwise eligible for SCP, Company X may self-correct these violations through December 31, 2019 (the end of the first plan year beginning after the year of the asset purchase), without regard to whether they represent significant violations, even though the violations occurred more than two plan years prior to the year of correction. The same rule would apply if Company X had simply assumed sponsorship of the Y plan, rather than merging the Y plan into the X plan.

What is an Insignificant Violation?

Whether a violation is insignificant is determined on the basis of all the facts and circumstances. The IRS will consider the following factors in determining whether a violation is insignificant.[103]

- *Whether other failures occurred during the period being examined*. (A particular type of operational failure that affected more than one participant is treated as one failure.)
- *The percentage of plan assets and contributions involved in the failure*. Obviously, the lower the percentage, the more likely the violation is insignificant.
- *The number of years during which the failure occurred*. The fewer the number of years involved, the better the argument that the violation is insignificant.
- *The number of participants affected relative to the total number of participants in the plan*. The lesser the percentage of the total participants who are affected, the more likely the IRS will view the violation to be insignificant.
- *The number of participants affected as a result of the operational failure relative to the number of participants who could have been affected by the failure*. The EPCRS procedure makes it clear that this factor is not to be interpreted by the IRS in a manner that would exclude small businesses. The IRS recognizes that a failure affecting a relatively small number of participants might nonetheless represent a large percentage of the total number of participants in a small business' plan.
- *Whether correction was made within a reasonable time after discovery of the failure*. This criterion helps most when SCP is raised in an audit. Where the plan sponsor has been diligent in correcting errors when they are discovered, there is a greater chance that such errors will be viewed as insignificant by the IRS field agent, and no sanctions will be proposed to close the examination of the plan. This highlights the importance of taking corrective steps, even if the plan sponsor is unsure whether the plan is eligible for SCP relief.
- *Why the operational failure occurred*. For example, if a violation was caused by data errors, such as errors in the transcription of data, the transposition of numbers or minor arithmetic errors, the IRS is more likely to treat the error as insignificant.

Substantial Correction Within Two-Year Period Is Sufficient

An employer may rely on SCP relief if a significant violation is substantially corrected by the end of the two-year correction period. Substantial correction recognizes that sometimes complete correction of the operational failure is not possible within the two-year correction period, but SCP relief should still be available if correction is completed within a reasonable period of time thereafter.

Insignificant Violation May Be Corrected at Any Time

If the operational failure is insignificant, there is no time limit under SCP for fixing the violation.[104] For example, an insignificant violation from the 2015 plan year could be fixed now under SCP. Such violation, even if not discovered

[103] Rev. Proc. 2016-51, §8.02
[104] Rev. Proc. 2016-51, §8.01.

until an audit of the plan, still would be eligible for SCP relief without having to negotiate a penalty under Audit CAP.

Using Plan Amendments to Cure Certain Operational Failures Under SCP

As a general rule, adopting a plan amendment to cure an operational failure (i.e., conforming the document retroactively to what was done in operation) under SCP is not acceptable. However, the EPCRS procedure allows three types of retroactive amendments that may be adopted to cure certain operational failures and further permits these retroactive amendments to be adopted through SCP.[105] These relate to:

- violations of the compensation dollar limit under IRC §401(a)(17);
- the making of hardship distributions or participant loans without authorizing plan language and
- the inclusion of an ineligible employee.

If a permitted retroactive amendment is adopted under SCP, qualification relief is not granted unless the amendment is submitted for a determination letter (assuming that the plan is eligible to obtain a favorable determination letter. Remember that prototype plans are not).[106]

VOLUNTARY CORRECTION WITH IRS APPROVAL PROGRAM (VCP)

The **Voluntary Correction with IRS Approval Program** (VCP) is a self-initiated program for fixing qualification failures. However, VCP requires disclosure to the IRS and a payment to the IRS (called a VCP compliance fee). VCP does not distinguish between significant and insignificant violations, like SCP does. There is also no time limit for using VCP.[107] However, an application under VCP cannot be filed if the plan is under IRS audit.

Formal Application

When resolution is sought through VCP, formal application must be made to the IRS to request a compliance statement with respect to the qualification failures identified in the letter that are being corrected under VCP. VCP submissions are made on IRS Form 8950 (Application for VCP Submission). In addition, the IRS requires the submission of Form 8951 to transmit the appropriate VCP compliance fee.

Streamlined VCP Submissions

Prior to 2013, certain streamlined submissions were available under VCP. With the introduction of Form 8950, a streamlined VCP application is no longer available. All submissions are now made on Form 8950, but Schedules 1 through 9 of Rev. Proc. 2013-12 provide descriptions of common qualification failures and standardized correction methods.

The IRS is encouraging applicants to include these schedules, where appropriate, in their VCP submission.[108] As a result, the documentation and processing of these failures are easier than they are for other, more uncommon concerns. Reduced VCP fees are also available for several of the scheduled submissions.[109]

Determination Letter Submission May be Required if Correction Involves Plan Amendment

To correct a plan document failure or a demographic failure under a VCP submission, an amendment to the plan is required. EPCRS also permits the use of a plan amendment to cure certain operational failures through the VCP pro-

[105] Rev. Proc. 2016-51, §4.05(2) and Appendix B, §2.07.
[106] Rev. Proc. 2013-12, §9.03.
[107] Rev. Proc. 2013-12, Part V, §§10 through 12.
[108] Rev. Proc. 2013-12, §11 and Appendix C, Part II.
[109] Rev. Proc. 2013-12, §12.02-.05.

cedure (or, in certain circumstances described above, through SCP). A determination letter application must be submitted to address a nonamender failure unless the plan is not eligible for a favorable determination letter filing (i.e., is a pre-approved plan). Furthermore, a determination letter submission may be required if the correction by amendment occurs during the last 12 months of the plan's remedial amendment cycle or in connection with a plan termination. Finally, the IRS retains discretion to require the submission of a determination letter application with respect to any amendment proposed or adopted to correct a qualification failure under VCP or Audit CAP.[110]

VCP Compliance Statement Issued by IRS

Relief under VCP is in the form of a compliance statement from the IRS, which addresses the failures identified, the terms of correction (including any revision of administrative procedures) and the time period within which proposed corrections must be implemented (including any changes in administrative procedures).[111] The compliance statement also provides that the IRS will not treat the plan as failing to satisfy the applicable requirements of the IRC on account of the failures described in the compliance statement if the conditions of the compliance statement are satisfied.

The corrections set forth in the compliance statement must be made within 150 days of the date of the statement.[112] Depending on the circumstances involved in the negotiations—in particular, if the original submission was substantially modified during the negotiation process—the plan sponsor may be required to sign the compliance statement and return it to the IRS within 30 days.[113]

The IRS may require verification that the corrections have been made, and that any administrative procedures required by the VCP compliance statement have been implemented.[114]

Group Submissions Under VCP

A VCP application may be submitted on a group basis by an Eligible Organization. This is referred to as a Group Submission. An Eligible Organization is defined as any of the following organizations:

- An M&P plan sponsor; (pre-approved plan sponsor)
- A volume submitter practitioner; (pre-approved plan sponsor)
- An insurance company that issues annuity contracts or provides services with respect to qualified plans or 403(b) plans; or
- An entity that provides its clients with administrative services with respect to qualified plans, 403(b) plans, SEPs and SIMPLE IRA plans.[115]

When an Eligible Organization submits a Group Submission under VCP, the individual plans involved in the submission do not submit individual applications under VCP.

If You're Curious . . .

Failures Eligible for Group Submissions

Only operational failures, plan document failures and employer eligibility failures caused by systematic errors involving the Eligible Organization may be submitted under Group Submission.[116] A single Group Submission may include more than one such failure, including a combination of operational failures and plan document failures.

[110] Rev. Proc. 2013-12, §6.05.
[111] Rev. Proc. 2013-12 §10.08.
[112] Rev. Proc. 2013-12, §10.07(9).
[113] Rev. Proc. 2013-12, §10.07(8).
[114] Rev. Proc. 2013-12, §10.07(11).
[115] Rev. Proc. 2016-51, §10.11(2).
[116] Rev. Proc. 2016-51, §10.11(1).

The correction method used to fix a failure must be applied on a consistent basis to all affected participants and beneficiaries in a plan being corrected, but the consistency requirement is applied on a plan-by-plan basis with respect to the plans covered by the Group Submission.[117] In other words, if there is more than one way to correct a failure, one method might be used by some of the plans included in the Group Submission, while another method is used by the other plans.

An Eligible Organization may not file a Group Submission under VCP unless the failure affects at least 20 plans and results in at least 20 plans implementing correction.[118]

A Group Submission under VCP is subject to the same procedures as any other VCP submission, except that the Eligible Organization is responsible for performing the procedural obligations normally imposed on the plan sponsor. However, the Eligible Organization must notify all plan sponsors whose plans are included in the Group Submission.[119] This notice must be given at least 90 days before the Eligible Organization furnishes the list of covered plan sponsors to the IRS. The notice requirement enables each plan sponsor to provide information that will need to be provided to the IRS as a condition of the VCP compliance statement and to decide if it wishes to be excluded from the Group Submission.

Closing a Group Submission Case

Within 120 days of receiving an unsigned compliance statement from the IRS, the Eligible Organization must return the signed compliance statement, as well as a list containing identifying information on the affected plans and their sponsors. The Eligible Organization must certify that each plan sponsor listed received notice of the Group Submission. The Eligible Organization also must certify that each plan sponsor timely filed Form 5500 for each affected plan.[120] Only the plans that actually implement correction no later than 240 calendar days after the date the compliance statement is signed (or such longer period agreed to by the IRS) are covered by that statement.

Anonymous Submission Under VCP

Any VCP submission may be made as an Anonymous Submission, regardless of the type of plan (qualified plan, 403(b) plan, SEP, SIMPLE IRA plan) or the type of failure (operational failure, demographic failure, plan document failure, employer eligibility failure).[121]

If You're Curious . . .

VCP Procedures Apply

The VCP procedures described above apply to an Anonymous Submission. A representative of the plan will submit an application, providing all the information and documentation required under other VCP applications, except that information identifying the plan or the plan sponsor is deleted.[122] The submission must provide an identification number that is unique to the submission, so that it may be identified. The power of attorney and the penalty of perjury statement need not be included with the initial submission. The state in which the plan sponsor is located must be identified in the initial submission. If a determination letter application will be requested as part of the submission

[117] Rev. Proc. 2016-51, §6.02(3).
[118] Rev. Proc. 2016-51, §10.11(2).
[119] Rev. Proc. 2016-51, §10.11(3)(b).
[120] Rev. Proc. 2016-51, §10.11(3)(c).
[121] Rev. Proc. 2016-51, §10.10.
[122] Rev. Proc. 2016-51, §10.10(1).

(e.g., for plan amendment needed to correct a demographic failure), the application should not be submitted until identifying information is provided to the IRS.[123]

Agreement with IRS

The IRS will work through the case with the representative and come to an agreement on the method of correction. The plan sponsor will have 21 days from the date of the letter of agreement to identify itself and the plan(s) involved.[124]

VCP Compliance Fees

Effective February 1, 2016, the IRS reduced the general VCP fees for most new submissions to encourage use of the VCP program to correct plan failures. The following compliance fees apply for VCP submissions.[125]

VCP Submission Fee for Qualified Plans

Number of Participants	Fee
20 or fewer	$500
21 to 50	$750
51 to 100	$1,500
101 to 1,000	$5,000
1,001 to 10,000	$10,000
Over 10,000	$15,000

The most recently filed Form 5500 series return is used to determine the number of participants.[126] If the plan is a terminated plan, the relevant Form 5500 is the one filed in the plan year prior to the plan year for which the final return was filed.

Additional or Alternative Fees for Certain VCP Applications

The following other fees may be applicable in addition to or in lieu of the fee shown in the above table.

- *Nonamenders*. The VCP submission fee for a nonamender case is 50 percent of the applicable fee above, but only if the application is submitted within one year of the expiration of the applicable remedial amendment period. If the application is submitted after such one-year period, the normal fee applies.[127]
- *Group submissions*. The initial fee is $10,000. If the submission involves more than 20 plans, an additional fee applies in the amount of $250 times the number of plans in excess of 20, with a cap of $50,000.[128]
- *Anonymous submissions*. In the case of an Anonymous Submission, the applicable fees above apply. However, if the case ultimately is not resolved under EPCRS (i.e., the submission is withdrawn rather than providing identifying disclosures to the IRS), 50 percent of the fee is refunded.[129]
- *Egregious failures*. If the failures are egregious or intentional (i.e., not the result of an oversight

[123] *Id.*
[124] *Id.*
[125] Rev. Proc. 2017-8, §6.08.
[126] Rev. Proc. 2016-51, §12.08.
[127] Rev. Proc. 2016-51, §12.03.
[128] Rev. Proc. 2016-51, §12.05.
[129] Rev. Proc. 2016-51, §10.07(7).

or mistake), a greater fee may be imposed, which is negotiated between the applicant and the IRS. The fee is based on a facts and circumtances methodology and negotiated with the IRS.

An egregious failure is an operational failure that is considered too severe to be resolved under SCP. The IRS gives as examples: (1) a plan that has consistently and improperly covered only HCEs, (2) a plan that provides more favorable benefits to an owner based on a purported collective bargaining agreement, where there has in fact been no good faith bargaining and (3) a defined contribution plan that has made contributions to HCEs that were several times greater than the dollar limit set forth in IRC §415.[130]

AUDIT CLOSING AGREEMENT PROGRAM (AUDIT CAP)

The Audit Closing Agreement Program (Audit CAP) arises when qualification failures are found in an IRS examination of the plan and the violation is not an insignificant operational failure that is eligible for relief under SCP. The IRS examination may arise as part of either an audit or a review in connection with a favorable determination letter application.

To obtain relief under Audit CAP, the employer must agree to correct the violation, pay a sanction and sign a closing agreement with the IRS.[131] The closing agreement is binding on the IRS and the plan sponsor with respect to the tax matters and periods specified in the agreement. If the parties are not able to reach an agreement, the IRS will proceed with the disqualification of the plan.

Sanction Under Audit CAP

The sanction charged to the plan sponsor is negotiated under Audit CAP.[132] The determination of the amount is based on facts and circumstances by the IRS and negotiated downward from there.

If You're Curious . . .

Factors Considered

In setting the Audit CAP sanction, the IRS considers the following factors:

- The steps taken by the plan sponsor to ensure that the plan had no failures;
- The steps taken to identify failures that may have occurred;
- The extent to which correction had progressed before the examination was initiated, including full correction;
- The number and type of employees affected by the failure;
- The number of NHCEs who would be adversely affected if the plan were not treated as qualified or as satisfying the requirements of IRC § 403(b), IRC §408(k) (SEPs) or IRC §408(p) (SIMPLE IRA plans);
- Whether the failure is a failure to satisfy the requirements of IRC §401(a)(4), IRC §401(a)(26) or IRC §410(b), either directly or through IRC §403(b)(12);
- The period over which the failure(s) occurred (for example, the time that has elapsed since the end of the applicable remedial amendment period under IRC §401(b) for a plan document failure); and
- The reason for the failure(s) (for example, data errors such as errors in transcription of data,

[130] Rev. Proc. 2016-51, §4.11.
[131] Rev. Proc. 2016-51, §13.
[132] Rev. Proc. 2016-51, §14.

the transposition of numbers or minor arithmetic errors).[133]

The following additional factors pertain only to qualified plans:

- Whether the plan has a favorable determination letter (sanction more likely to be lower if there is a letter);
- Whether the plan has both operational failures and other failures (sanction more likely to be lower if all failures are operational failures);
- The extent to which the plan has accepted transferred assets (failures relating to transferred assets, especially if they occurred before the transfer, is a mitigating factor); and
- Whether the failures were discovered during the determination letter process.[134]

Furthermore, if a qualified plan has transferred assets arising from a corporate merger, acquisition or similar employer transaction, and no new incidents of the failures that relate to the transferred assets occur later than the end of the second plan year that begins after the employer transaction, the sanction under Audit CAP will not exceed the sanction that would apply if the transferred assets were maintained as a separate plan.[135]

ELIGIBILITY REQUIREMENTS FOR RESOLUTION PROGRAMS

Eligibility Requirements for SCP

To use the SCP program, the following requirements must be satisfied.[136]

- The qualification failure must be an operational failure.
- If the plan is a qualified plan or 403(b) plan, it must satisfy the favorable letter requirement if the operational failure is a significant violation.
- The plan must satisfy the practices and procedures requirement.
- In the case of a significant operational failure, the plan or plan sponsor must not be under examination, unless the failure has been corrected (or substantially corrected) as of the date the plan or plan sponsor is considered under examination.
- The violation must not be an egregious failure.

If You're Curious . . .

If the plan is a SEP or SIMPLE IRA plan, the operational failure must be insignificant to use the SCP program. In addition, if the plan is a SEP, the plan must be a valid adoption of the IRS' Model SEP Form 5305-SEP or Form 5305A-SEP or the plan must be a prototype SEP with a current favorable opinion letter. If the plan is a SIMPLE IRA, the plan must be a valid adoption of the IRS' Model Form 5305-SIMPLE or 5304-SIMPLE or a prototype SIMPLE plan with a current favorable opinion letter.

Eligibility Requirements for VCP

All qualification failures can be resolved through VCP: operational failures, plan document failures, demographic failures and employer eligibility failures. The only eligibility requirement is that the plan not be under examination when the VCP request is submitted. The practices and procedures requirement and the favorable determination let-

[133] Rev. Proc. 2016-51, §14.02.
[134] *Id.*
[135] Rev. Proc. 2016-51, §14.03.
[136] Rev. Proc. 2016-51, §4.

ter requirement for SCP eligibility are not applicable to VCP submissions. In addition, egregious failures are eligible for VCP.

If the VCP application is an Anonymous Submission, and the plan comes under examination before the IRS receives identifying information about the plan, the plan is no longer eligible for VCP and must withdraw the submission.[137] On the other hand, if an identified plan receives an audit notice when the VCP is pending, the audit will be delayed until the VCP is complete.[138]

Misuse or Diversion of Plan Assets

If a qualification failure involves the diversion or misuse of plan assets, relief under EPCRS is not available, not even under Audit CAP.[139]

Definitions Important to Eligibility Requirements

Favorable Letter Requirement for Qualified Plan

If the favorable letter requirement applies to self-correction of a qualified plan violation under SCP, the plan must be able to satisfy at least one of the following conditions:[140]

- A current favorable opinion letter, if the plan is an adoption of a pre-approved plan;
- A current favorable determination letter, if the plan is an individually designed plan

Practices and Procedures Requirement

If this requirement applies, it is satisfied only if the plan sponsor or plan administrator has established practices and procedures that are reasonably designed to promote and facilitate overall compliance with the qualification requirements.[141] Practices and procedures may be formal or informal. The use of checksheets is cited as an example of established practices and procedures.

Under Examination Limitation

SCP (except for insignificant operational failures and substantially corrected significant operational failures) and VCP are not available if the plan or plan sponsor is under examination.

If You're Curious . . .

A plan is considered to be under examination if any of the following circumstances exists:[142]

- An IRS examination of the plan (e.g., examination of Form 5500) has already commenced.
- The plan is under investigation by the Criminal Investigation Division of the IRS.
- The plan sponsor (or a representative) has received verbal or written notification from the IRS of an impending plan examination or of a referral for a plan examination.
- An IRS examination has been completed, and the case is in Appeals or in litigation.
- The plan is aggregated with a plan described in the above three categories for purposes of satisfying any of the coverage or nondiscrimination testing requirements.

[137] Rev. Proc. 2016-51, §10.10(2).
[138] Rev. Proc. 2016-51, §10.04.
[139] Rev. Proc. 2016-51, §4.12.
[140] Rev. Proc. 2016-51, §5.01(4).
[141] Rev. Proc. 2016-51, §4.04.
[142] Rev. Proc. 2016-51, §5.09.

- With respect to qualification issues for which a plan is aggregated with a plan described in the four categories above, the plan is also considered to be under examination. Examples of such qualification issues would be the IRC §402(g) limit [by reason of IRC §401(a)(30)], the IRC §415 limits and the top-heavy rules.
- The plan sponsor has submitted any Form 5300 series form (relating to a determination letter application) and the Employee Plans agent notifies the plan sponsor, or a representative, of possible qualification failures, whether or not the plan sponsor is officially notified of an examination.

An examination commenced on a corporation's tax return (Form 1120) would not cause qualified plans maintained by that corporation to be considered under examination unless one of the circumstances listed above is applicable.

Summary of Eligibility Requirements

The table below summarizes the eligibility requirements under the various EPCRS programs.

To qualify for a particular program, the plan must satisfy all items that are marked "Yes."

Eligibility Requirement	SCP (Qualified Plan)	VCP	Audit CAP
(1) Violation must be an operational failure	Yes	No	No
(2) Operational failure must be insignificant	No	No	No
(3) The plan document must be one of the applicable IRS model forms or an approved prototype document.	No	No	No
(4) The plan must have a favorable determination, opinion or advisory letter.	Yes, unless insignificant failure	No	No
(5) Plan or plan sponsor must not be under examination	Yes, unless insignificant failure	Yes	No
(6) Plan must have established practices and procedures	Yes	No	No
(7) Correction generally must be completed by the end of the 2nd plan year following the year of the failure	Yes, unless insignificant failure	No	No
(8) Violation must not be egregious or intentional	Yes	No*	No
(9) Violation must not involve misuse or diversion of assets	Yes	Yes	Yes
*Egregious failures may be corrected under the VCP, but the Audit CAP sanctions may be applied to the VCP, instead of the normal VCP fee.			

CORRECTION PRINCIPLES

The IRS procedure outlines certain correction principles that are common to all three methods. These are as follows:

Restore Plan to the Position It Would Have Been in Had the Error Not Occurred

Under this principle, the goal is to have the plan resemble as closely as possible what it would be like had the error not occurred. Therefore, correction methods that would change the result significantly generally are disfavored.

In particular, the plan sponsor generally will be required to make necessary contributions to ensure that each participant's account is restored to its proper value. This correction must include not only principal amounts but also a crediting of the investment earnings that the amounts would have earned had they been deposited timely[143]

[143] Rev. Proc. 2016-51, §6.02(1).

Consider the Terms of the Plan at the Time the Operational Error Was Made

Generally, the goal is to match plan operations to the language in the plan. In **EXAMPLE 1-5** in section 1.08, the correction would likely be to restore the improperly forfeited accounts (with earnings) and to pay terminated participants the proper amounts due them.[144]

On relatively rare occasions, the IRS will permit the correction under EPCRS to be a plan amendment so that the plan provisions match actual practice. An example of this is when a 401(k) plan permits participants to take hardship withdrawals notwithstanding the fact that the plan does not permit such distributions. In that situation, the IRS will permit the plan to be amended retroactively to permit hardship withdrawals.

Correction Method Should Resemble a Regulatory Method, if Applicable

Some operational failures or demographic failures have specific correction methods stated in the regulations, which should be the preferred correction method.[145] The IRS' EPCRS procedure includes approved correction methods for certain violations. If applicable, these correction methods are deemed to be reasonable and permissible.

Correction Should Be Reasonable and Appropriate Under the Circumstances

The IRS acknowledges that there may be many ways to correct a given disqualifying failure, and will consider situations under which unusual corrections should be permitted.[146]

Correction of a Failure That Occurs in More Than One Year Should Be Consistent for All Years

Although the IRS has acknowledged that a given error is capable of being corrected in several ways, the plan sponsor must choose one manner of correction for an error that occurs several times and/or over several plan years.[147]

Source of Corrective Allocations

The source of the corrective allocations must be either employer contributions or forfeitures, if forfeitures are used under the plan to reduce employer contributions. Plan investment earnings are not permitted to be used for the correction.[148]

Full Correction for All Plan Years

If an error has occurred historically over several years, the EPCRS correction procedures require that the error be corrected for all affected years, even if the years are closed for audit purposes.[149] This is commonly the most expensive part of EPCRS. Furthermore, it raises data gathering and accuracy challenges, often causing the plan sponsor to spend significant funds and energy to locate the necessary information for the correction. Nonetheless, the IRS generally insists on full correction for each year, so that no participant's benefit is left uncorrected.

There are some exceptions to full correction. If full correction is unreasonable or not feasible, then full correction might not be required.[150] In such a situation, the correction method adopted must not have significant adverse effects on the participants and benefits and must not discriminate significantly in favor of HCEs.

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[144] Rev. Proc. 2016-51, §6.02.
[145] Rev. Proc. 2016-51, §6.02(2)(a).
[146] Rev. Proc. 2016-51, §6.02(2).
[147] Rev. Proc. 2016-51, §6.02(3).
[148] Rev. Proc. 2016-51, §6.02(4)(c).
[149] Rev. Proc. 2016-51, §6.02.
[150] Rev. Proc. 2016-51, §6.02(5).

Keep Assets in Plan, if Possible

A correction method generally should keep the assets in the plan.[151] For example, suppose an amount was incorrectly allocated to a participant, but it did not exceed the IRC §415 limits. Such amount should be reallocated to other participants or, if appropriate, used to reduce future employer contributions, rather than be returned to the employer (unless the mistake of fact exception under Revenue Ruling 91-4 applies). Of course, this rule does not apply if the failure relates to a required distribution [e.g., minimum distribution required under IRC §401(a)(9)] or where the IRC or regulations would provide for corrective distributions.

Adjust Corrective Allocations or Distributions for Earnings

Earnings for purposes of the EPCRS Procedure means an adjustment of a principal amount to reflect subsequent investment gains and losses through the date of the corrective allocation or corrective distribution, unless otherwise provided in a specific section of the EPCRS Procedure.[152] Earnings generally should be based on the actual earnings performance of the trust assets.[153] To the extent earnings are being calculated for corrective contributions or allocations under a defined contribution plan, Rev. Proc. 2016-51, Appendix B, §3 outlines some specific earnings allocation methods.

If the earnings are negative, a corrective contribution or allocation need not reflect the loss.[154] If investments are individually directed by the participant, the plan may use the rate-of-return for the best-performing investment option for the years in question, rather than looking at the specific rate-of-return for the affected participant's or beneficiary's account, so long as most of the employees receiving the corrective allocations are NHCEs.[155]

The calculation of earnings may be done using reasonable estimates.[156]

Using Plan Amendments to Correct Failures

Whether a plan amendment is necessary, or even permitted, to correct a qualification failure depends on the type of failure involved.

Plan Document and Demographic Failures

A plan document failure will always involve the adoption of a corrective amendment to the plan. Depending on the nature of the plan provision missing or incorrectly stated in the plan, a corrective amendment for a plan document failure may also involve restoring benefits to certain participants or beneficiaries. A demographic failure also might involve a corrective amendment.

Operational Failures

For operational failures, a plan amendment generally is not required, and in most cases is not permitted. The corrective action required for an operational failure is to conform the administration of the plan to the terms of the plan document, not the other way around. However, as discussed above, amendments to conform the plan document to actual practice are permitted on occasion.

Demographic Failures

When a plan fails coverage requirements under IRC §401(a)(26) or IRC §410(b), or when it fails nondiscrimination

[151] Rev. Proc. 2016-51, §6.02(2)(b).
[152] Rev. Proc. 2016-51, §5.04.
[153] Rev. Proc. 2016-51, §6.02(4).
[154] Rev. Proc. 2016-51, §6.02(4)(a).
[155] Rev. Proc. 2016-51, Appendix B, §3.01(3)(b).
[156] Rev. Proc. 2016-51, §6.02(5)(a).

testing requirements under IRC §401(a)(4), either additional NHCEs will need to accrue benefits for the year in which the failure occurs, or the benefits of existing participants who are NHCEs will need to be increased. An amendment will have to be adopted to reflect the additional participants or increased benefits, unless an increase in benefits can be made pursuant to a discretionary employer contribution feature already in the plan. The rules found in Treas. Reg. §1.401(a)(4)-11(g) should be followed when correcting a demographic failure.

Section 1.09: Review of Key Concepts

- What is a qualified plan?
- What are the primary tax advantages of a qualified plan?
- How does qualification in operation differ from qualification as to form?
- List five qualification requirements.
- What is the difference between an individually designed plan, and a pre-approved plan?
- What is the difference between a plan document and a trust agreement?
- Describe an SPD, the contents and the timing requirements for disclosure.
- Describe an SMM and the timing requirements for disclosure.
- Describe the different types of IRS letters, including opinion and determination.
- Explain when it is appropriate to submit a plan to the IRS for a favorable determination letter.
- Explain how to request a letter of determination.
- Describe the purpose of Form 2848.
- What are the tax consequences of plan disqualification?
- Describe the EPCRS program and its purpose.
- Describe SCP, VCP and Audit CAP.
- What is the difference between an operational and a document failure?
- What is the difference between an insignificant and a significant violation?

Section 1.10: For Practice – True or False

1. A qualified plan may rely on operational compliance alone.
2. A plan sponsor is not required to submit the plan to the IRS for a letter of determination.
3. The consistent failure of a plan to make the required minimum distributions (RMDs) under IRC §401(a)(9) could disqualify a plan.
4. A qualified plan must accept a direct transfer of an eligible rollover distribution.
5. A sponsoring organization must expect to have at least 15 employer-clients adopting a basic plan document.
6. Form 5307 is used to request a determination letter for an individually designed plan.
7. An opinion letter is issued to the sponsoring organization of apre-approved plan.
8. SCP may be used to correct a significant operational failure as long as it is corrected or substantially corrected within the two-year correction period.
9. The plan sponsor may use Audit CAP even if the plan is currently under IRS audit.
10. An SMM must be provided to each participant and each beneficiary who is receiving benefits under the plan no later than 210 days after the close of the plan year in which the amendment was adopted.

Section 1.11: Sample Test Questions

1. All of the following statements regarding qualified plans are TRUE, EXCEPT:
   A. They must provide for participant loans.
   B. They must limit benefits or contributions under IRC §415.
   C. They must allow for eligible rollover distributions to another eligible retirement plan.
   D. They must contain provisions protecting benefits in the event of a merger with another plan.
   E. They must provide for RMDs under IRC §401(a)(9).

2. Which of the following statements regarding plan qualification under §401(a) is/are TRUE?
   I. A qualified plan may not permit the assignment of benefits under any circumstances.
   II. A contribution may be returned to the employer if it was made due to a mistake of fact.
   III. Participant accrued benefits must be protected upon plan merger.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

3. All of the following are advantages of having a qualified plan, EXCEPT:
   A. Tax-deductible employer contributions
   B. Earnings on employer contributions are tax deductible to the employee
   C. Deferred taxation to the employee on employer contributions
   D. Most distributions are eligible for rollover
   E. Deferred taxation on trust earnings

4. All of the following statements regarding plan documents are TRUE, EXCEPT:
   A. An pre-approved plan consists of a basic plan document and a trust document.
   B. An pre-approved plan must be maintained by a sponsoring organization.
   C. A pre-approved plan receives an opinion letter from the IRS not a determination letter
   D. An individually designed plan may request for a letter of determination upon establishment or termination
   E. An individually designed plan is not pre-approved by the IRS.

5. Which of the following statements regarding plan documents is/are TRUE?
   I. An opinion letter is issued to a sponsoring organization of a pre-approved plan.
   II. Pre-approved plans must be updated during a six year cycle set by the IRS
   III. A determination letter is issued to the plan sponsor of an individually designed plan.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

6. All of the following statements regarding VCP are TRUE, EXCEPT:
   A. It may be used to correct significant qualification violations.
   B. It may be used to correct insignificant qualification violations.
   C. It may be used to correct egregious failures.

D. It may be used even if the plan does not have a determination letter.
E. It may be used by plans currently under examination.

7. All of the following statements regarding SCP are TRUE, EXCEPT:
   A. It may be used to correct significant qualification violations.
   B. It may be used to correct insignificant qualification violations.
   C. It may be used to correct egregious failures.
   D. It is used to correct operational failures.
   E. It involves no disclosure or fees to the IRS.

8. Which of the following is/are potential disqualification issues addressed under EPCRS?
   I. Plan document failures
   II. Catastrophic failures
   III. Demographic failures
   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

9. All of the following statements regarding notices to participants of plan provisions and amendments are TRUE, EXCEPT:
   A. The SPD must be written in a manner that is reasonably expected to be understood by the average plan participant.
   B. For an existing plan, a participant must receive the SPD no later than 30 days after he or she first becomes eligible to participate.
   C. For a new plan, a participant must be receive the SPD no later than 120 days after the later of the effective date or the adoption date of the plan.
   D. A beneficiary is not required to receive an SPD until 90 days after he or she begins to receive benefits from the plan.
   E. An SMM is required when there has been a material modification to the plan or when the information provided in the SPD has changed.

10. Which of the following statements regarding plan disqualification is/are TRUE?
   I. The employer loses its deduction for vested contributions made to a plan that is disqualified.
   II. The NHCEs may be taxed on vested contributions, unless the plan is disqualified solely due to a coverage violation.
   III. Taxes may apply if a distribution from a disqualified plan was rolled over and resulted in an excess contribution to an IRA.
   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

See next page for answers to the true/false and sample test questions.

Section 1.12: Solutions to True or False Questions

1. False. A plan is not qualified unless it satisfies the requirements of the law in both form (plan document) and operation.
2. True.
3. True.
4. False. A qualified plan must permit employees to transfer eligible rollover distributions to a qualified plan. However, a qualified plan is not required to accept rollovers.
5. True.
6. False. Form 5300 is used for individually designed plans.
7. True
8. True.
9. True.
10. True.

Section 1.13: Solutions to Sample Test Questions

1. The answer is **A**. Although it is very common to allow for participant loans in a qualified plan, it is not a requirement.
2. The answer is **D**. A qualified plan may permit the assignment of benefits in limited circumstances.
3. The answer is **B**. Taxation on earnings is deferred. It is not a deduction to be taken by plan participants.
4. The answer is **A**. An preapproved plan document consists of a basic plan document and an adoption agreement or may be in a single document format.
5. The answer is **E.** All of the statements are true.
6. The answer is **E.** To use VCP to correct a violation, the plan must not be under examination.
7. The answer is **C**. SCP may not be used to correct egregious failures.
8. The answer is **C**. The potential disqualification issues addressed by EPCRS include plan document failures, operational failures, demographic failures and employer eligibility failures.
9. The answer is **B**. For an existing plan, a participant must receive the SPD no later than 90 days after he or she first becomes a participant.
10. The answer is **D**. If the plan is disqualified, the employer loses its deduction for nonvested contributions made to the plan for open tax years,

CHAPTER 2:
TYPES OF PLANS

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Section 2.01: Key Terms

- Automatic enrollment
- Defined benefit plan
- Defined contribution plan
- Designated Roth contribution
- Elective contributions
- Employee benefit plan
- Employee pension benefit plan
- Employee stock ownership plan (ESOP)
- Employee welfare benefit plan
- Employer matching contribution
- Money purchase plan
- Nonelective contribution
- Nonpension plan
- Pension plan
- Profit sharing plan
- Qualified automatic contribution arrangement (QACA)
- Roth 401(k) plan
- Safe harbor 401(k) plan
- Section 401(k) plan
- Simplified employee pension (SEP)
- SIMPLE IRA
- SIMPLE 401(k) plan
- Stock bonus plan
- Target benefit plan

Section 2.02: Introduction

There are several different ways to categorize qualified retirement plans. When the different types of categorization are applied depends on the reason for differentiating between types of plans.

One of the most common differentiation methods is to look at how benefits are earned in a plan. Some plans, called defined benefit plans, promise a specific benefit at retirement. Other plans, called individual account plans or defined contribution plans, work like savings accounts. These plans define the contribution going in and then a participant's benefit is the accumulated contributions and earnings credited to the participant's account.

The Employee Retirement Income Security Act of 1974 (ERISA) and labor regulations define what constitutes an employee benefit plan and then provide two categories of employee benefit plans: employee pension benefit plans and employee welfare benefit plans.

Treasury regulations outline two main types of retirement plans: pension plans and nonpension plans.

In this chapter, we will discuss the different categories of plans briefly and then outline in more detail the characteristics of different types of defined contribution plans. How plans are categorized by Treasury and Labor rules often controls how plans operate and understanding these categories often makes operational rules easier to comprehend. Specific characteristics or features of plans, like eligibility, top-heavy, coverage, allocations, minimum funding, deductions and vesting, are covered in more detail later in the book.

Section 2.03: General Categories of Retirement Plans

DEFINED CONTRIBUTION VS. DEFINED BENEFIT PLANS

A **defined contribution plan**, also known as an individual account plan, maintains an individual account balance for each participant. A participant's benefit is based solely on the value of the account balance. The account balance will reflect contributions, forfeitures and investment earnings allocated to the account during the employee's period of participation; in other words, a participant's account balance in a defined contribution plan represents his or her share of the value of the trust assets.

When the participant takes a distribution of his or her account balance, the amounts paid will be based on the value of the account balance at that time (or as of the most recent valuation date specified in the plan). The account balance that will be available to provide benefits at retirement (or upon any distribution event) is not guaranteed, because fluc-

tuations in the value of assets directly affect the account balance. Because the size of a participant's benefit at retirement depends in part on the amount of investment returns experienced by the participant's account, the participant is considered to bear the risk of investment losses: if the plan investments do not earn as much as one would hope, the participant's benefit will be less. If the plan earns more than anticipated, the participant's benefit will be better than expected. Because of the direct link between investment returns and the ultimate benefit enjoyed by the participant, many defined contribution plans permit participants to direct the investments for their own accounts.

The law defines a **defined benefit plan** to be any plan other than a defined contribution plan.[1] That means a defined benefit plan does not maintain account balances to reflect the accrued benefits of the plan participants. Instead, the amount available to provide benefits at retirement is determined by a formula stated in the plan. A defined benefit plan must provide definitely determinable benefits.[2] To satisfy this requirement, a plan must define the benefit formula and how benefits are accrued or earned under that formula.

The employer that sponsors a defined benefit plan is required to fund the plan sufficiently to provide benefits. The funding will come from employer contributions and the investment returns that the contributions earn in the trust. The risk of investment loss in a defined benefit plan is borne by the plan sponsor. If the investments earn better than expected, these earnings will cover a greater share of the cost of the plan and the employer will contribute less. If the investments lose money or perform worse than expected, the employer will need to contribute more to make up the difference.

Most qualification rules apply equally to both defined contribution plans and defined benefit plans. The following qualification requirements have different rules depending on which type of plan is being addressed:

- Nondiscrimination testing [IRC §401(a)(4)], including permitted disparity [IRC §401(l)];
- Treatment of forfeitures [IRC §401(a)(8)];
- Minimum distributions [IRC §401(a)(9)];
- Provision and calculation of qualified joint and survivor annuity [IRC §§401(a)(11) and 417];
- Limitations under IRC §415;
- IRC §401(a)(26) (minimum participation test) applies only to defined benefit plans;
- Five-year break-in-service rule under vesting requirements [IRC §411(a)(6)(c)] applies only to defined contribution plans and fully insured defined benefit plans; and
- The manner of calculating top-heavy minimum benefits ([IRC §416].

In addition to the qualification requirements outlined above, IRC §404(a) applies different deduction rules based on whether a plan is a defined benefit plan or a defined contribution plan.

ERISA DEFINITION: EMPLOYEE BENEFIT PLANS

The term employee benefit plan is an ERISA term and has no bearing on the tax qualification rules. Only employee benefit plans are covered by ERISA and subject to the reporting, fiduciary and enforcement rules in Title I of ERISA. Employee benefit plans are divided into two categories:

- **employee pension benefit plans** and
- **employee welfare benefit plans**.

The difference between a pension and a welfare plan is in the type of benefits provided. The "pension" designation refers to retirement benefits or the deferral of income to termination of employment or beyond. The "welfare" designation refers to benefits such as health, life or disability that are provided for the welfare of the participants and their beneficiaries (which are not the focus of this book).

As will be discussed below, the Internal Revenue Code (IRC) and related regulations also discuss pension and nonpension plans. The pension term used for qualification purposes does not have the same meaning as when that term is used

[1] IRC §414(j), ERISA §3(35).

[2] Treas. Reg. §1.401-1(b)(i)(I).

in ERISA. All qualified plans that are subject to ERISA fall into the employee pension benefit plan category, regardless of whether the plan may have a pension or nonpension designation for qualification purposes.

PENSION PLANS VS. NONPENSION PLANS

Pension Plans

Under Treasury Regulations relating to plan qualification, a pension plan is a plan intended to provide for the livelihood of the employees or their beneficiaries after the retirement of such employees through the payment of benefits determined without regard to company profits.[3] Specifically, a **pension plan** is one that is:

> established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his or her employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees.[4]

Under the regulation quoted above, the first major requirement is for a pension plan to have definitely determinable benefits—that is, there must be either a formula for determining the participant's benefit at retirement or a definite formula for determining the company's annual contribution to the plan. Defined benefit plans are always pension plans.

Certain defined contribution plans, such as money purchase plans and target benefit plans, are pension plans. Although the ultimate retirement benefit is not definite in a money purchase plan or a target benefit plan (i.e., the benefit is the account balance), these plans are deemed to satisfy the definitely determinable benefits rule because the employer's annual contribution is predetermined by a formula outlined by the plan. This formula determines how much will be contributed and allocated to each participant. Because the employer's contribution is determinable, a benefit can be projected to normal retirement age (NRA) based on the assumption that the contribution formula will continue to apply in future years. Of course, the actual investment experience of the trust's assets will affect the value of the account balance and, in turn, the ultimate benefit payable from the plan. But the uncertainty of the future investment experience does not cause the plan to fail to be a pension plan.

The second major requirement for a pension plan is that it may not permit in-service withdrawals of benefits except after the participant has attained NRA. Therefore, pension plans may not provide for withdrawals to participants on the occurrence of a hardship or upon a stated event or the simple passage of time.[5]

Nonpension plans

These are plans that do not satisfy the requirements to be pension plans.

Nonpension plans do not have to satisfy the definitely determinable benefits requirement. The employer may have discretion to determine the amount to be contributed each year. There are two types of nonpension plans:

- profit sharing plans and
- stock bonus plans.

Section 401(k) plans are nonpension plans because they are classified as either profit sharing plans or stock bonus plans. Although a nonpension plan need not satisfy the definitely determinable benefits requirement, it must provide for a definite allocation formula, which outlines the method by which the employer's contribution is allocated among the plan participants' accounts once that contribution is made to the plan.

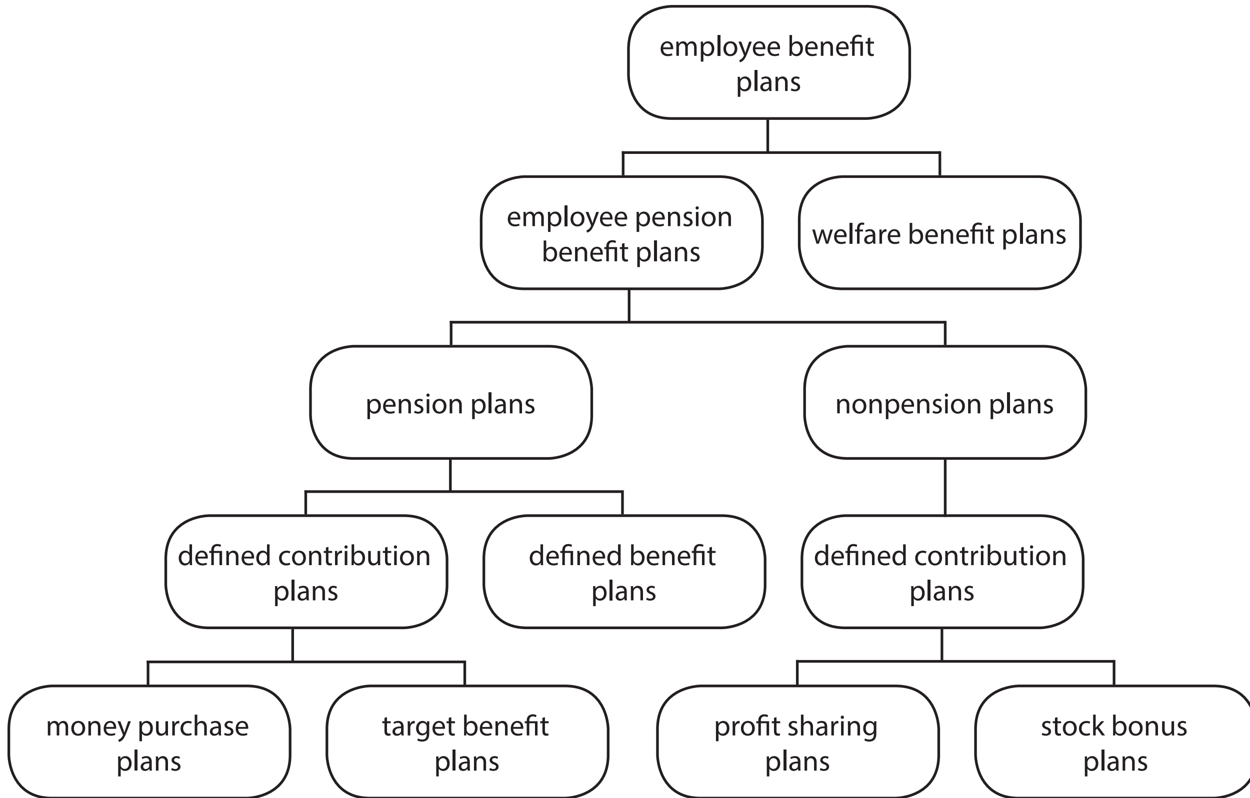
A profit sharing plan is a defined contribution plan under which the employer's contribution each year may be determined at the employer's discretion. No contribution is mandatory, although contributions over the years must be

[3] Treas. Reg. §1.401-1(a)(ii).
[4] Treas. Reg. §1.401-1(b)(I).
[5] Treas. Reg. §1.401-1(b)(1)(I).

recurring and substantial.

A stock bonus plan is a defined contribution plan under which benefits are distributable in employer stock.[6] A stock bonus plan is essentially the same as a profit sharing plan, except that it is designated as a stock bonus plan and becomes subject to certain IRC requirements that are applicable only to stock bonus plans.

Below is a chart that reflects the plan categories discussed above and their relation to one another.



Rules Affected by Labeling

The following rules apply differently for pension and nonpension plans:

- As discussed above, the definitely determinable benefit requirement is applied solely to pension plans.
- The permissible distribution events are different for pension plans and nonpension plans.
  - o Pension plans may permit distribution only upon retirement, death, disability, termination of employment and in-service distributions to a participant who has reached age 62, even if NRA is later than age 62.[7]
  - o Nonpension plans may permit distribution upon any stated event specified in the plan [with some exceptions with respect to distributions of elective contributions under 401(k) plans].
- Only pension plans must comply with the minimum funding requirements of IRC §412. This means that the plan sponsor is required to make certain contributions and is subject to excise taxes if it does not do so.
- Only pension plans are required to comply with the qualified joint and survivor rules of IRC §417; a nonpension plan must comply with those rules only if it fails to satisfy the exemption in IRC §401(a)(11).
- Only nonpension plans may include a 401(k) arrangement (subject to a limited exception for pension plans in existence prior to ERISA).

[6] Treas. Reg. §1.401-1(b)(1)(iii).
[7] IRC §401(a)(36).

Below is a table that reflects these rules as they apply to pension and nonpension plans.

Rule / Feature	Applies to Pension Plan?	Applies to Nonpension Plan?
Definitely determinable benefit requirement	Yes	No
Distribution upon retirement, death, disability or termination of employment	Permitted	Permitted
In-service distribution to a participant under age 62	Not permitted	Permitted
In-service distributions to a participant age 62 or older	Permitted	Permitted
Minimum funding requirements	Yes	No
Qualified joint and survivor rules	Yes	No – provided exemption requirements are met
401(k) arrangement	Not permitted	Permitted

Section 2.04: Types of Defined Contribution Plans

PROFIT SHARING PLANS

A **profit sharing plan** is one type of nonpension defined contribution plan. Because the plan is a nonpension plan, the employer's contribution is not required to be fixed. The most common contribution formula in a profit sharing plan is a discretionary formula under which the employer determines each year the amount to contribute. Typical plan language would be: "*The company will contribute to the trust for each plan year an amount it determines in its discretion*."

A plan may have a more definite contribution formula, such as a fixed percentage of compensation or a fixed percentage of profits. For example, a plan's contribution formula might state that, each plan year, the employer will contribute an amount that equals 5 percent of its net profits, or an amount that equals 4 percent of the total compensation of all eligible participants.

A profit sharing plan may have more complex contribution formulas if the employer does not want a purely discretionary contribution formula. If a profit sharing plan includes a definite contribution formula, the document also may grant the employer the discretion to contribute additional amounts for any plan year.

When the contribution formula is based on the employer's profits, or is contingent on the employer's having profits, the plan document must define profits. An employer is not required to have profits to contribute to a profit sharing plan, unless the plan document requires so expressly.[8]

If the contribution formula is discretionary, the employer may decide not to contribute at all for a particular plan year. Treas. Reg. §1.401-1(b)(2) simply requires that there be recurring and substantial contributions to the plan.

A failure to contribute for several years, or to make recurring and substantial contributions, may result in accelerated vesting.[9] If there is deemed to be a complete discontinuance of contributions in a profit sharing plan, it is tantamount to a plan termination, and all affected participants are required to be fully vested as a result.

A profit sharing plan must have a definite allocation formula, meaning the plan must be clear as to how an employer contribution will be allocated to participants' accounts.[10] For example, if the employer contributes $50,000 to the trust under a discretionary contribution formula, the allocation formula will determine how that $50,000 is divided among

[8] IRC §401(a)(27)(A).
[9] IRC §411(d)(3).
[10] Treas. Reg. §1.401-1(b)(1)(ii).

the participants' account balances. If the employer contributes under a fixed formula, the allocation formula still must prescribe how the contribution amount is allocated.

There are many approaches a plan may take in allocating contributions. Regardless of how contributions are allocated, the plan must define compensation for purposes of these allocations, and the dollar limit on compensation found in IRC §401(a)(17) ($275,000 for 2018, increased for cost of living) must apply for this purpose.

If You're Curious . . .

Reasons to Establish a Profit Sharing Plan

A key advantage of the profit sharing plan is that the employer can have flexibility in determining its annual contribution to the plan by using a discretionary contribution formula. This way, the employer is able to contribute more during years of high profitability, and less when business is not as good, without having to amend the plan's contribution formula. This option may be especially attractive to a start-up company, a company that has an erratic profitability or a company that frequently acquires other companies and may need some flexibility on a year-to-year basis with respect to the annual qualified plan contribution.

In addition, a profit sharing plan is one of only two types of plans that are permitted to offer a section 401(k) arrangement, which will be discussed below.

The total maximum amount that may be contributed to profit sharing plans and deducted by the company [in addition to elective contributions that are contributed through a 401(k) feature] is 25 percent of total eligible compensation paid by the company to participants.

The IRC §415 limits and the way they are applied to defined contribution plans may be a consideration in deciding whether to establish a profit sharing plan and whether to maintain another plan in addition to the profit sharing plan. Although all defined contribution plans are treated similarly under IRC §415, a defined benefit plan may provide a better vehicle for maximizing retirement benefits under the IRC §415 limits. IRC §415 limits will be discussed in more depth in Chapter 7.

Profit Sharing Plans Permitted to have more Flexible Distribution Rules

The events permitting withdrawals are much broader for profit sharing plans (nonpension plans) than for pension plans. Whereas a pension plan is intended to provide benefits after retirement, a profit sharing plan is intended to accumulate funds for withdrawal upon the occurrence of one or more of several stated occasions. As a result, it is permissible for a profit sharing plan to allow participants to take in-service withdrawals if certain conditions are met.

Profit sharing plans may (but are not required to) permit withdrawals on:

- Hardship;
- The attainment of a stated age;
- Anytime after the contributions have been in the plan for at least two years;
- Anytime after the participant has been in the plan for at least 60 months; or
- Disability (even if the participant's employment is not terminated).

EXAMPLE 2-1. Hardship Withdrawal from Profit Sharing Plan. A profit sharing plan permits a participant to receive an in-service withdrawal for financial hardship. Jon's house is severely damaged by a tornado. The plan's administrative committee determines that the financial cost of repairing this damage constitutes a hardship and allows Jon to take sufficient funds from the plan to repair his house. This is permissible.

EXAMPLE 2-2. Hardship Withdrawal Not Permitted from Pension Plan. The amount of funds in Jon's profit sharing account is insufficient to fully repair his house. Jon's employer also sponsors a defined benefit pension plan. Jon applies to the company for a hardship withdrawal from the defined benefit plan. The law does not permit a pension plan to make an in-service withdrawal, so the request for a hardship withdrawal from the defined benefit plan must be denied.

MONEY PURCHASE PLANS

A **money purchase plan** is a type of pension plan. As discussed above, a pension plan must provide for the payment of definitely determinable benefits over a period of years (usually life) after retirement.[11] To satisfy this definitely determinable benefits requirement, a money purchase plan must provide a fixed contribution formula.

Whatever formula is chosen must be one that provides a method for calculating the employer's contribution that is not subject to the employer's discretion and is not geared to the profits of the company. In other words, the employer is obligated to make its contribution for each plan year, even if it turns out that the employer is not profitable for that year. To change the contribution amount required by the formula, the employer must amend the plan.

The employee's benefit that is accrued under the money purchase plan is the account balance that accumulates for the employee through the allocation of contributions, forfeitures and investment earnings, just like under the profit sharing plan. Although this is not a definite benefit, because a definite account balance at retirement cannot be guaranteed under a defined contribution plan, the plan is deemed to satisfy the definitely determinable benefits requirement by providing for a fixed employer contribution formula.

As with profit sharing plans, money purchase plans experience considerable flexibility as to how contributions are allocated. The only requirements are that the formula not be impermissibly discriminatory and that it be defined in the plan document.

Allocation Formulas

A money purchase plan may have an allocation formula that determines how the contribution is divided up among participants' accounts. A common approach is to have the allocation formula mirror the contribution formula, because the contribution formula has to be definite. For example, suppose the contribution formula requires the employer to contribute an amount equal to 10 percent of each participant's compensation. In such case, the allocation to each participant could be 10 percent of his or her compensation, to mirror that contribution amount.

On the other hand, the allocation formula may be different from the formula used for determining the contribution. If this approach is desired, the contribution formula is usually expressed as a uniform percentage of compensation, but the amount so determined is allocated among the eligible participants in a different manner.

Qualified Joint and Survivor Annuity (QJSA)

Money purchase plans are required to provide a qualified joint and survivor annuity (QJSA) as a distribution option.[12] Under this option, benefits are paid while either the participant or his or her spouse is alive.

Minimum Funding Requirements

IRC §412 imposes minimum funding requirements on pension plans, including money purchase plans. Under a money purchase plan, the funding requirement is generally the annual contribution (plus any contributions due for prior years that have not been made by the employer).

[11] See Treas. Reg. §1.401-1(b)(1)(I).
[12] IRC §§401(a)(11) and 417.

If You're Curious . . .

Reasons to Establish a Money Purchase Plan

If the employer could have the flexibility of a discretionary contribution under a profit sharing plan, why would it choose to establish a money purchase plan? Some employers like the discipline required in the maintenance of the money purchase plan. By establishing a fixed contribution, which the employer is required to make, the employer knows how much to budget for the year. In addition, the money purchase approach gives the employees assurance that a contribution will be made every year, promoting longevity with the company. If the employee must still be employed at the end of the year to share in the allocation of that contribution, the employee has an incentive to continue employment, being assured that a contribution will be made by the employer and allocated to the participant's account if he or she is employed at year end.

A money purchase plan is a popular defined contribution plan choice of unions because it obligates the employer to contribute, thereby reinforcing the collectively bargained benefit.

One reason to use a money purchase plan is as a vehicle for the sole purpose of accepting rollovers from a terminating defined benefit plan. Since money purchase pension plans do not have the profit sharing plan requirement of recurring and substantial contributions, a money purchase plan with a contribution formula of 0 percent of compensation could be established and funded solely with rollover contributions.

Another reason to use a money purchase plan is the safe harbor rule under IRC §414(n)(5). Under that rule, if a leasing organization maintains a money purchase plan with a minimum contribution rate of 10 percent of compensation, 100 percent immediate vesting and immediate participation, the employees covered by that plan are not treated as leased employees of the recipient employer, so long as no more than 20 percent of the recipient's nonhighly compensated workforce consists of leased employees. If the leasing organization maintains a profit sharing plan, even with the same contribution and participation requirements, this safe harbor rule is not satisfied.

Reasons Not to Adopt a Money Purchase Plan

As with profit sharing plans, IRC §415 requirements may favor the adoption of a defined benefit plan instead of a money purchase pension plan.

Except in the limited case of a pre-ERISA money purchase plan, a money purchase plan may not include a 401(k) arrangement. This also may influence an employer's decision to choose a profit sharing plan over a money purchase plan.

Historically, the driving force for most employers to establish a money purchase plan was that the deduction limits for these plans were greater than those for profit sharing plans. With the elimination of the difference between the deduction limits for money purchase plans and profit sharing plans, money purchase plans have become much less popular.

SECTION 401(k) PLANS

A profit sharing plan or stock bonus plan (which will be discussed below) may include a 401(k) arrangement. The name "401(k) arrangement" comes from the fact that the IRC section that permits this type of arrangement is IRC §401(k). Plans that contain this kind of arrangement are called **section 401(k) plans**.

A plan that includes a 401(k) arrangement is often referred to as a 401(k) plan. However, it is more technically accurate to think of a 401(k) plan as a profit sharing plan or stock bonus plan that includes a 401(k) arrangement, even if the

employer does not make contributions to the plan other than the contributions elected by the employees.

State and local government employers are prohibited from adopting a 401(k) plan (unless they are eligible under certain grandfather rules).

If You're Curious . . .

A money purchase plan may not be used as a vehicle to provide a 401(k) arrangement, unless it was in existence on June 27, 1974, and otherwise satisfies the definition of a pre-ERISA money purchase plan discussed in IRC §401(k)(6).

Types of Employer Contributions Made to a 401(k) Plan

The contribution formula in a 401(k) plan may include a combination of the following types of contributions:

- Elective contributions;
- Employer matching contributions; or
- Nonelective contributions.
- After-tax contributions

Elective contributions are employer contributions made at the election of the employees, in lieu of paying such employees cash compensation. These contributions represent the 401(k) arrangement feature that gives the plan its designation as a 401(k) plan. Without a 401(k) arrangement, the plan is just a regular profit sharing plan or a regular stock bonus plan.

Employer matching contributions are contributions that are allocated on the basis of the elective contributions. In other words, they are matching the amount, or a percentage of the amount, of the elective contributions.

Nonelective contributions are contributions made by the employer that are not determined by the employees' elections. Elective contributions, as described above, are determined directly by the elections made by the employees. Employer matching contributions are determined with reference to the amount of the employees' elective contributions. Nonelective contributions are determined without regard to the amount of the elective contributions.

After-tax contributions are contributions made by a participant that are not deductible. Often they are used by employees to supplement their retirement.

The only contributions that you will always see in a 401(k) plan are the elective contributions. The plan may, but is not required to, provide for employer matching contributions and nonelective contributions. The plan is treated as a type of profit sharing plan or stock bonus plan, as designated by the document, regardless of which types of contributions are provided, even if elective contributions are the only contributions made by the employer.

If You're Curious . . .

Top-heavy rules prevent some employers from sponsoring plans that only provide for elective contributions. The top-heavy rules require a top-heavy plan to provide minimum contributions to non-key employees.[13] This minimum contribution requirement is invoked only when there are employer contributions made on behalf of the key employees. Although an elective contribution under a 401(k) arrangement is treated as an employer contribution for most purposes (including the determination of whether a key employee has received a contribution for purposes of invoking the minimum contribution obligation), it does not satisfy the employer's obligation to make minimum contributions on behalf of the non-key employee to a top-heavy plan.[14] Thus, if top-heavy rules require the employer to make minimum contributions to the 401(k) plan, it will not be possible to have a 401(k)

[13] IRC §416.

[14] Treas. Reg. §1.416-1, M-20.

plan under which the only contributions are elective contributions. The elective-contribution-only structure of the 401(k) plan could be maintained, however, if either none of the key employees makes any elective contributions (i.e., so that the highest contribution rate provided to any key employee is 0 percent) or the top-heavy minimum is provided in another plan sponsored by the employer.

A 401(k) plan that consists solely of a safe harbor cash or deferred arrangement, as described in IRC §401(k)(12) or IRC §401(k)(13), and employer matching contributions that satisfy the safe harbor requirements of IRC §401(m)(11) or IRC §401(m)(12), is deemed to be not top-heavy.[15] Although this rule will eliminate the requirement to guarantee a top-heavy minimum contribution, the employer will still have to make contributions to the plan because a minimum employer matching contribution or nonelective contribution is required to satisfy the safe harbor requirements. Thus, even a safe harbor 401(k) plan that is deemed to be not top-heavy cannot be structured so that the only contributions are elective contributions.

Elective Contributions

The 401(k) arrangement in the plan must provide for a contribution formula that describes how the amount of the elective contributions is determined. The employer is required to transmit these amounts to the plan as part of its contribution.

An employee's election to defer compensation is usually done through a salary reduction agreement (also called a salary reduction election or deferral election). The employer then contributes to the plan an amount equal to the employee's election, and reduces the compensation actually paid to the employee in the same amount. Hence, the employee has *elected* to *defer* receipt of this compensation, and the contribution is sometimes referred to as an elective deferral.

EXAMPLE 2-3. Salary Deferral Elections. Michael is a participant in a profit sharing plan with a 401(k) arrangement. Michael's salary is $480 per week ($24,960 per year, if there are 52 weekly payroll periods). He enters into a salary reduction agreement to defer 3 percent of compensation to the 401(k) arrangement. Pursuant to this agreement, the employer withholds 3 percent of his weekly compensation (that is, 3% x $480, or $14.40 per week). Assuming 52 pay periods in the year, this works out to a total contribution for the year of $748.80. The amounts withheld are contributed by the employer to the plan as part of its contribution. In other words, Michael is instructing the employer to pay him less compensation than he would otherwise be paid for each pay period and to defer that compensation to the plan as part of the employer's contribution made on Michael's behalf.

The employee cannot make an election to defer compensation that is already currently available at the time of the election.[16] Compensation is currently available as of a date if the compensation has already been paid by such date, or the employee currently is able to receive the cash at the employee's discretion.

EXAMPLE 2-4. Currently Available Compensation. Brianna wants to participate in her employer's 401(k) plan for 2018. She receives her first paycheck on July 15, 2018 and asks the Human Resource Director if she can defer 5 percent of her paycheck. Because Brianna has already received her July 15th paycheck, this amount is currently available to her and, thus, not available for deferral into the 401(k) plan. Brianna may elect to defer 5 percent of her next paycheck as that amount is not currently available to her.

[15] IRC §416(g)(4)(H).
[16] Treas. Reg. §1.401(k)-1(a)(3)(iii).

If You're Curious . . .

This rule regarding currently available compensation is based on constructive receipt principles in the IRC. Normally, when a taxpayer is in control of whether to receive taxable compensation or have it deferred, the constructive receipt principles treat the amount as received by the taxpayer, even if he or she elects to have it deferred, resulting in immediate taxation. IRC §401(k) creates a statutory exception to the constructive receipt rule, by allowing employees to control whether to receive compensation through the salary reduction election.

Employees cannot elect to defer compensation that becomes available before the 401(k) arrangement is established.[17] The 401(k) arrangement is established as of the later of (a) the date the arrangement is adopted or (b) the date the arrangement is effective.

EXAMPLE 2-5. Currently Available Compensation. ABC Company adopts a 401(k) plan on July 30, by executing a prototype adoption agreement on such date. The plan is effective retroactive to the preceding January 1. The later of the adoption date or the effective date is the July 30 adoption date. Therefore, salary reduction agreements may apply only to compensation that becomes currently available after such July 30.

The fact that only post-July 30 compensation may be deferred to the plan in **EXAMPLE 2-5** does not affect the period for which compensation is measured for other purposes, such as any plan limitation on the percentage of compensation that may be deferred or the compensation used to calculate deferral percentages for purposes of performing nondiscrimination testing.

When we hear the term salary reduction agreement we usually think in terms of an amount being withheld from a regularly scheduled paycheck. However, the employee might not receive a regular paycheck or the employee might receive separate bonuses from time to time. The salary reduction agreement may apply to these non-regular compensation payments, so long as the election to defer from such payments is made before the payments are currently available to the employee.

A sole proprietor or a partner of a partnership may be an eligible participant under the employer's 401(k) plan. The employer of these individuals is the sole proprietorship (i.e., the individual himself) or partnership, depending on the context.[18] These types of participants are known as self-employed individuals. For elective contribution purposes, the self-employed individual's compensation [known as earned income under IRC §401(c)(2)] is not treated as currently available until the end of the sole proprietorship's or partnership's tax year. Thus, the salary reduction election to defer earned income for such year may be made up to the end of that year.[19]

The plan document must define what compensation means for purposes of the salary reduction elections. Normally, a 401(k) plan will permit eligible employees to make salary reduction elections in relation to all forms of compensation, whether it is base salary, overtime wages, commissions, bonuses or other forms of taxable compensation. But the plan document may restrict the applicability of elections to only certain forms of compensation (such as base salary only).

If You're Curious . . .

A 401(k) arrangement may be designed so that the election is to take a portion of an employer's discretionary contribution in cash, rather than to reduce compensation under a salary reduction agreement. For example, the employer might agree to contribute an amount that equals 5 percent of compensation for each participant, but the plan permits each participant to make an election to receive all or part of his or her share of that contribution in cash instead. When the 401(k) arrange-

[17] Treas. Reg. §1.401(k)-1(a)(3)(ii) (August 8, 1991) and Treas. Reg. §1.401(k)-(a)(3)(iii) (December 29, 2004).
[18] IRC §401(c)(4).
[19] Treas. Reg. §1.401(k)-1(a)(6).

ment is structured this way, the portion of the employer's contribution that the participant elects not to receive in cash is treated as an elective contribution, in the same manner as an elective contribution made under a salary reduction agreement. This is in effect the reverse of a salary reduction election. Under a salary reduction election, the employee is electing to reduce current compensation in exchange for an elective contribution to the plan. In the cash election approach, the employee is electing to increase current compensation in exchange for not having the employer make the contribution to the plan on the employee's behalf. The bottom line is the same—the amount contributed on the employee's behalf to the plan, as a result of the election, is an elective contribution under the 401(k) arrangement.

A 401(k) arrangement is sometimes referred to as a cash or deferred arrangement or CODA. This term is descriptive of the election made by the employee. The employee is electing between cash compensation and deferral to the plan. In the elective contribution context, the employee receives more cash compensation if he or she does not elect to reduce pay. In the election in the last paragraph, the employee receives more cash compensation if he or she elects not to have the employer make the employee's allocable share of the employer contribution designated for the plan.

Before elective contributions may be made on an employee's behalf, the employee must first qualify as a plan participant. As a participant, the employee is then eligible to make elective contributions, as described above. An employee who is eligible to, but chooses not to, make an elective contribution is still a participant for other purposes. For example, the employee may be entitled to an allocation of nonelective contributions.

Eligibility for Elective Contribution Feature

Although the IRC's eligibility rules permit a plan to require an employee to work two years before entering the plan, such a provision is not permitted in relation to the 401(k) arrangement. At the most, a plan may require completion of one year of service for eligibility to participate in the 401(k) feature of the plan.[20] A plan still may require more than one year of service for eligibility to participate in the profit sharing or matching feature of the plan.

Automatic (or Negative) Enrollment

Some 401(k) plans use an automatic enrollment approach to obtain elective contribution elections from eligible employees. Under **automatic enrollment**, the plan provides that, as of the plan entry date when the employee is first eligible for the 401(k) plan, the employee is automatically enrolled at a default elective contribution rate. The employee is free to change the automatic enrollment by signing a form that specifies a different elective contribution rate or on which the participant opts against making elective contributions at all. Because the employee has to make a contrary election to avoid the automatic enrollment, this enrollment approach is sometimes referred to as negative enrollment.

If You're Curious . . .

Treasury regulations specifically permit automatic enrollment, and contributions deducted from an employee's cash compensation pursuant to an automatic enrollment provision are elective contributions under IRC §401(k).[21] Although an employee who is enrolled automatically has not made a formal election to defer compensation, he or she is deemed to have made an election because the employee had an opportunity to file a contrary election that would result in no elective contribution or a different rate of elective contribution.

In keeping with the goal of encouraging participation in the private retirement plan system, and more particularly, to encourage employee savings under 401(k) arrangements, Congress enacted legislative provisions to remove certain obstacles to automatic enrollment (such as, the potential

[20] IRC §401(k)(2)(D).

[21] Rev. Rul. 98-30; Rev. Rul. 2000-8; Treas. Reg. §1.401(k)-1(a)(3)(ii) (December 9, 2004).

effect of state anti-garnishment statutes),[22] address liability issues (such as, fiduciary responsibility for the investment of the employee contributions made through automatic enrollment),[23] and respond to administrative concerns (such as, participant withdrawal rights).[24] These considerations acted as an impediment to employers instituting automatic enrollment. Furthermore, certain automatic enrollment structures now constitute safe harbor plans, and do not need to test elective contributions for nondiscrimination.[25]

Safe Harbor 401(k) Plans

The elective deferrals and any employer matching contributions or after-tax employee contributions made to a 401(k) plan must pass certain nondiscrimination testing. The nondiscrimination test for elective deferrals is called the actual deferral percentage test (ADP test). The nondiscrimination test for employer matching contributions is called the actual contribution percentage test (ACP test). These tests generally compare the rate of elective deferrals (or employer matching and after-tax employee contributions) by the HCEs to the rate for the NHCEs. The two rates must be within a certain tolerance range of each other, or corrections must be made, usually involving the return of elective deferrals to HCEs and the forfeiture of the associated employer matching contributions.

The IRC provides two different types of 401(k) plans that may avoid the need to perform nondiscrimination testing on elective deferrals, referred to as **safe harbor 401(k) plans** - the traditional safe harbor 401(k) plan as described in IRC §401(k)(12) and the **qualified automatic contribution arrangement (QACA)** under IRC §401(k)(13) that is available only to plans that provide for automatic enrollment.

401(k) plans and safe harbor 401(k) plans are discussed in detail in *The ASPPA Defined Contribution Plan Series Volume 2: 401(k) Plans and Intermediate Administrative Topics, which is available at the ASPPA* bookstore (ecommerce.asppa-net.org).

Roth 401(k) Plans

A 401(k) plan may permit participants to make designated Roth contributions [in which case it generally is referred to as a Roth 401(k) plan].[26] Designated Roth contributions are not excludable from gross income like a non-Roth (or pre-tax) elective contribution, but special tax rules apply to qualifying distributions from designated Roth accounts that allow the participant to receive such payments (which include both the designated Roth contributions and the earnings thereon) tax-free.

In order for a plan to accept designated Roth contributions, the plan document must specifically permit the use of designated Roth contributions.[27] The amendment to add the Roth feature must be made by not later than the last day of the plan year in which such feature is effective.[28]

Roth deferral elections. The participant must affirmatively designate the elective contribution as a designated Roth contribution for these rules to apply. This designation may apply to all or a portion of the participant's elective contributions. A Roth designation is irrevocable with regard to elective contributions that have occurred. Thus, a participant may not reassign previously contributed pre-tax elective contributions as designated Roth contributions (or vice versa). A participant may, however, change his or her designation for future deferrals.[29]

[22] ERISA §514(f).
[23] ERISA §404(c)(5).
[24] IRC §414(w).
[25] PPA §902, adding new IRC §§401(k)(13) and 401(m)(12).
[26] IRC §402A.
[27] Treas. Reg. §1.401(k)-1(f)(1).
[28] Rev. Proc. 2005-66, §5.05.
[29] Treas. Reg. §1.401(k)-1(f)(1).

If You're Curious . . .

There is a procedure whereby the participant's entire pre-tax account including earnings may be converted to a Roth account if the plan so provides. If this is done, the participant pays taxes on the amount being converted in the year of conversion.[30] Internal Roth conversions are discussed in detail in *The ASPPA Defined Contribution Plan Series Volume 2: 401(k) Plans and Intermediate Administrative Topics*, which is available at the ASPPA bookstore (ecommerce.asppa-net.org).

If a plan provides for automatic enrollment, the plan may specify that the automatically enrolled contributions are designated Roth contributions, and such designation will be considered to be an irrevocable designation by the affected participants.[31]

Although the ability to make Roth contributions to an IRA is limited if the taxpayer has adjusted gross income in excess of certain amounts, such limits do not apply to 401(k) plans that offer designated Roth contribution features.

Treatment of designated Roth contributions for other purposes. Except for the taxability of the contribution when made and the distribution when received, designated Roth contributions are treated the same as pre-tax elective contributions. They, along with any pre-tax elective contributions, are subject to:

- the limit on elective deferrals under IRC §402(g);
- the limit on annual additions under IRC §415;
- ADP testing;
- normal 401(k) distribution restrictions;
- required minimum distribution (RMD) rules for participants over age 70½; and
- top-heavy rules (i.e., they are used to measure top-heavy status in the same manner as pre-tax elective contributions).

Designated Roth contributions are deductible by the employer in the same manner as other elective contributions.

Accounting obligations. The plan must separately account for designated Roth contributions, keeping track of what portion of the Roth account is attributable to the contributions and what portion constitutes earnings thereon. Furthermore, the plan must keep a record of the calendar year in which the participant made his or her first designated Roth contribution, as this is important for distribution taxation purposes.[32]

Distribution rules for designated Roth contributions. Designated Roth contributions are subject to the same distribution limitations as are pre-tax elective contributions. Designated Roth contributions are always fully vested.

A qualified distribution from a designated Roth account is entirely tax-free. A qualified distribution is one that satisfies both of the following requirements:

- the distribution is on account of death, disability or after the attainment of age 59½; and
- the distribution is made after the end of the five-taxable-year period beginning on the January 1 of the first year in which the participant made designated Roth contributions to the plan.[33] The five-year period is called the nonexclusion period.

If a distribution is made that does not comply with these two requirements, the portion of the distribution attributable to the designated Roth contributions is returned to the employee tax-free. The earnings portion is taxable to the employee. All designated Roth account distributions that are not qualifying distributions will be made up partly of designated Roth contributions and partly of earnings, based on the ratio of the total earnings to the total value of the designated Roth account.

[30] IRC §492A(c)(4)(E); Notice 2013-74, IRB 2013-52 (12/11/13).
[31] Treas. Reg. §1.401(k)-1(f)(4)(ii)(B).
[32] Treas. Reg. §1.401(k)-1(f)(2)., Treas. Reg. §1.402A-2, Q&A-1.
[33] IRC §402A(d)(2).

STOCK BONUS PLANS

A **stock bonus plan**, like a profit sharing plan, is a nonpension plan. The primary difference is that, under a stock bonus plan, the benefits are distributable in employer stock.[34] A stock bonus plan has the same contribution and allocation formula options as a profit sharing plan. Most of these plans provide for a discretionary contribution formula and may adopt any of the allocation formulas available to profit sharing and money purchase pension plans. The employer is permitted to make its contribution in the form of its own stock. If the employer makes cash contributions, the fiduciaries usually invest those contributions exclusively or primarily in employer stock.

ESOPS

An **employee stock ownership plan** (ESOP) may be a stock bonus plan, or a combination of a stock bonus plan and money purchase plan.[35] An entire plan may be designated as an ESOP or a portion of a plan may be designated as an ESOP.[36] If only a portion of a plan is designated as an ESOP, the other portion of the plan will be characterized as one of the other types of defined contribution plans described in this section. An ESOP (or an ESOP portion of a plan) must be designed to invest primarily in employer securities.[37] The contribution and allocation formulas under an ESOP normally operate under the same rules as discussed above for profit sharing plans. However, an ESOP may not allocate employer contributions using a permitted disparity (that is, Social Security integrated) formula.[38]

If You're Curious . . .

An ESOP may obtain employer stock in one of two ways: the employer may contribute stock rather than cash or the ESOP may use its liquid assets to buy stock. If the stock is publicly traded, the ESOP may buy the stock on the market. If it is not, the employer may issue stock for sale to the ESOP or may sell treasury stock to the ESOP, or the ESOP may purchase the stock from existing shareholders in a private sale. Under normal circumstances, a qualified plan making a purchase from the employer or certain shareholders would be a prohibited transaction. However, ERISA contains a statutory exemption from the prohibited transaction rules for this sale.[39]

One characteristic that separates an ESOP from other plan types is its ability to borrow money to purchase larger blocks of employer stock. The ESOP may borrow the money from either a third-party commercial lender (such as a bank) or from the employer, itself (which may, in turn, borrow money to lend to the ESOP, in what is often called a mirror loan). If a third-party lender is used, it is common for the employer to guarantee the loan (which would also be a prohibited transaction, but for a statutory exemption).[40] The employer will then make contributions each year sufficient to enable the ESOP to make that year's payment on the loan.[41]

The only security that the ESOP may give to the lender on the loan is the securities that are purchased with the loan proceeds and future contributions that are made by the employer to repay the loan. When the loan is first taken, the purchased shares are used in their entirety to secure the loan, and so are placed in a suspense account. As loan payments are made each year, a portion of the shares is released from encumbrance and taken out of the suspense account to be allocated to participants' accounts as contribution. When the loan is fully repaid, all shares will have been allocated and

[34] Treas. Reg. §1.401-1(b)(1)(iii).
[35] IRC §4975(e)(7).
[36] DOL Reg. §2550.407d-6(a)(4).
[37] IRC §4975(e)(7)(A).
[38] Treas. Reg. §1.401(l)-1(a)(4)(ii).
[39] IRC §4975(d)(13); ERISA §408(e); DOL Reg. §2550.408e.
[40] IRC §4975(d)(3); ERISA §408(b)(3); DOL Reg. §2550.408b-3.
[41] Treas. Reg. §54.4975-7(b)(5).

the suspense account will be reduced to zero.[42]

An employer may deduct dividends paid on employer securities held by an ESOP.[43] These dividends may be used to repay an exempt loan. If the dividends are used to repay the loan, additional securities are released from the suspense account. If dividends paid on allocated shares (that is, shares already allocated to participant account balances) are used to repay the exempt loan, the participant must receive an allocation of employer securities from the suspense account that have a fair market value at least equal to the amount of the dividend.[44] Dividends are deductible only if the employer stock is from a C corporation.[45]

IRC §1042 Transactions

IRC §1042 allows a shareholder to sell certain employer securities to an ESOP and defer recognition of the gain on the sale by reinvesting in the securities of one or more other U.S. corporations. If all the requirements of IRC §1042 are satisfied, the selling shareholder does not recognize any gain until he or she sells the reinvested securities. This may permit the gain to be deferred throughout the shareholder's lifetime. One of the requirements to qualify for this deferral is that the plan may not allocate shares for the benefit of the selling shareholder, certain relatives of the selling shareholder or any other owner of more than 25 percent of the company's stock (including attribution from certain relatives and from the owner's account in the ESOP, if any). If improper allocations are made, an excise tax is charged to the corporation equal to 50 percent of the improperly allocated shares.[46]

S Corporation ESOPs

The law permits an ESOP to be maintained by an S corporation and to hold the S corporation's stock.[47]

An ESOP that holds employer securities in an S corporation must provide that no portion of the plan attributable to (or allocable in lieu of) such employer securities may accrue during a nonallocation year to certain participants, called disqualified persons.[48] If the ESOP makes a prohibited allocation, an excise tax is imposed on the S corporation and the disqualified person is treated as having received a distribution in the amount of the prohibited allocation. The stated purpose of the allocation restrictions is to ensure that ESOPs are established for S corporations to provide broad-based employee coverage, and to benefit rank-and-file employees as well as HCEs and historical owners.

TARGET BENEFIT PLANS

A **target benefit plan**, like a money purchase plan, is a pension plan. In fact, a target benefit plan is a type of money purchase plan. The plan satisfies the definitely determinable benefits requirement by providing a formula (called the target benefit) that defines the intended benefit at retirement, similar to the type of formula used in a defined benefit plan. An example of a target benefit formula is 50 percent of average annual compensation payable as a life annuity starting at age 65. Unlike a defined benefit plan, a target benefit plan does not guarantee the target benefit at retirement age. Instead, the purpose of a target benefit formula is solely to determine the amount of the annual employer contribution.

[42] Treas. Reg. §54.4975-7.
[43] IRC §404(k).
[44] IRC §404(k)(2)(B).
[45] IRC §404(k)(1).
[46] IRC §4979A.
[47] IRC §1361(b)(1)(B).
[48] IRC §409(p).

The contribution formula in a target benefit plan is an actuarial calculation applied to the target benefit formula, using certain interest rate and mortality assumptions. That contribution amount, subject to the limits for defined contribution plans under IRC §415, is allocated to the participant's account. Because a target benefit contribution is based on such actuarial considerations as the years available to fund the target benefit, the contribution will be greater for an employee who is older than it will be for a similarly situated employee who is younger.

If You're Curious . . .

The only regulation that describes a method for determining the employer's contribution is under IRC §401(a)(4), relating to nondiscrimination testing.[49] Target benefit plans that use the regulatory formula not only satisfy the definitely determinable benefits requirement, but also satisfy the nondiscrimination requirements on a safe harbor basis. The regulatory method is not the exclusive means of determining target benefit contributions, but target benefit plans that deviate from the regulatory method must conduct annual nondiscrimination testing on the employer contributions.

In a target benefit plan, the allocation formula always mirrors the contribution formula. In other words, the contribution determined for each participant under the contribution formula is the amount allocated to that participant's account.

EXAMPLE 2-6. Target Benefit Plan. ABC Corp.'s target benefit plan provides a target benefit of 50 percent of average compensation, payable as a life annuity at 65. Tyson's projected annual target benefit, based on his current average compensation of $40,000, is $20,000. Using the factors prescribed by the plan, the administrator determines that an employer contribution in the amount of $7,650 must be made on Tyson's behalf for the plan year. This contribution is less than the IRC §415 limit of the lesser of 100 percent of compensation ($40,000 for Tyson) or $53,000 (for 2016), so the administrator will allocate to Tyson's account $7,650 of the employer's total contribution for that plan year.

When a target benefit plan participant terminates or retires, he or she receives the value of the vested account balance, which may be more or less than the target benefit.

Under currently permissible profit sharing designs, the manner in which allocations are made under target benefit plans may be achieved through a profit sharing plan allocation. (These are called "age weighted" allocations, and represent a more complex manner in which to divide up profit sharing contributions.) Prior to 2002, target benefit plans were used instead of, or in addition to, profit sharing plans because they permitted the higher 25 percent maximum deduction limit, whereas profit sharing plans were then limited to the 15 percent deduction level. Now that the deduction limits for profit sharing plans are the same as for target benefit plans, target benefit plans are much less popular.[50]

SIMPLIFIED DEFINED CONTRIBUTION PLANS

In an attempt to provide for plan structures that may be maintained by smaller employers with less administrative complexity, Congress has enacted rules for three different types of simplified plans: Simplified Employer Pension Plans (SEPs) and Simple Incentive Match Plan for Employees [SIMPLE IRAs, and SIMPLE 401(k)] plans.

SEP

A **Simplified Employee Pension** (SEP) is essentially an employer-provided Individual Retirement Account (IRA). A trust is not established, as for qualified plans. Instead, the employer contributes directly to SEP IRAs for the partici-

[49] Treas. Reg. §1.401(a)(4)-8(b)(3).
[50] IRC §404(a)(3).

pants. A SEP document signed by the employer outlines the eligibility requirements, how the employer's contribution to the SEP is determined and the limitations on the contributions. SEP requirements are found in IRC §408(k).

Contributions made to a SEP are excludable from the employee's income if the SEP satisfies the requirements outlined below.[51]

Participation Requirements

The employer must contribute to a SEP IRA for each employee who satisfies the following requirements:[52]

Age Requirement

A SEP may have a minimum age requirement up to age 21.

Service Requirement

A SEP may require the employee to have performed service for the employer in at least three of the last five years. No minimum number of hours may be required in any such year. Because the service requirement is measured over the prior five years, a new employee's participation in a SEP may be delayed until his or her fourth year of employment.

EXAMPLE 2-7. SEP Eligibility and Entry. A SEP requires an employee to have service in at least three of the last five calendar years. Jeremy is hired in 2017. He has service in 2017, 2018 and 2019. As a result, the 2020 calendar year includes the first day of a year after which Jeremy has completed service in at least three of the five prior years. His first SEP contribution will be made for 2020.

A SEP is not permitted to require that an employee be employed on a certain date, such as the last day of the plan year, to receive a contribution.[53]

If You're Curious . . .

Compensation Requirement

The SEP may require the employee to receive a minimum amount of compensation in the current plan year.[54] The minimum compensation amount is a dollar amount announced each year by the IRS. For 2018, the dollar amount is $600. Indexing occurs for cost of living in $50 increments.

For purposes of this requirement, compensation means IRC §415 compensation, as is used to determine whether an employee is an HCE.

All members of controlled groups or affiliated service groups are treated as a single employer for purposes of the SEP participation rules. All employees of the related group that satisfy the participation requirements must be eligible for the SEP.

If an employee is eligible for the SEP contribution, he or she may establish a SEP IRA or the employer must do so for the participant.[55] The employee must receive the SEP contribution in a year in which he or she is eligible.

[51] IRC §402(h).
[52] IRC §408(k)(2).
[53] Prop. Treas. Reg. §1.408-7(d)(3).
[54] IRC §408(k)(2)(C).
[55] Prop. Treas. Reg. §1.408-7(d)(2).

Uniform Allocation Requirement

The SEP contributions must bear a uniform relationship to compensation.[56] Compensation for this purpose is capped at the maximum under IRC §401(a)(17) ($275,000 for 2018).[57] Generally, a uniform relationship means that the contribution must be allocated pro rata to compensation—that is, the same percentage of compensation must be allocated to each eligible participant. Nonetheless, a permitted disparity formula, which provides a larger allocation to those participants whose compensation exceeds the Social Security Taxable Wage Base, is permitted.[58] In addition, a rate of contribution that decreases as compensation increases (that is, provides a lower contribution to higher paid participants) is also deemed to be uniform.[59] Compensation for purposes of the allocation of contributions may be any amount permitted under IRC §414(s).

The allocation formula must be written in the SEP document.[60]

Withdrawals

A SEP may not restrict an employee's right to withdraw amounts contributed to his or her IRA.[61] The employee is free to withdraw funds from the SEP IRA in accordance with the IRA document. If the employee is under age 59½ when he or she receives distributions, the employee is subject to the 10 percent penalty tax under IRC §72(t) unless an exception applies.

Contribution Maximum

The SEP contribution is excludable from income so long as it does not exceed 25 percent of compensation. Compensation for this purpose is an amount permitted under IRC §414(s), but only to the extent that the compensation is included in gross income.

The exclusion is individual to each participant, not to the aggregate of all participants. Therefore, the actual allocation to the participant's account may not exceed the 25 percent limitation.

If the contribution exceeds the limitation, the excess is deemed to be distributed to the employee, and is includible in income under the IRA distribution rules.[62] The deemed distribution of the excess SEP contribution is then treated as if it were re-contributed by the employee as a traditional IRA contribution.[63] If the excess is removed from the IRA by the due date (including extensions) of the participant's federal income tax return for the year in which the excess contribution was made, no excise tax applies. If it is not refunded, and it is not deductible as a regular IRA contribution, the excess is subject to a 6 percent excise tax.[64]

Employer Deduction

The employer's deduction for the SEP contribution is the amount contributed on behalf of the participants, up to 25 percent of the aggregate compensation of all SEP participants.[65]

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[56] IRC §408(k)(3)(C).
[57] IRC §408(k)(8).
[58] IRC §408(k)(3)(D).
[59] Prop. Treas. Reg. §1.408-8(c)(1).
[60] IRC §408(k)(5).
[61] IRC §408(k)(4).
[62] IRC §408(d).
[63] IRC §402(h)(2).
[64] IRC §4973.
[65] IRC §404(h)(1)(C).

SARSEPs

Prior to 1997, it was possible for an employer to establish an elective contribution arrangement under which contributions were made to SEP IRAs, which was called a Salary Reduction Simplified Employee Pension (SARSEP). While contributions are still permitted to SARSEPs that were formed before 1997, no new SARSEPs may be established.[66]

Vesting

All contributions to the SEP must be nonforfeitable.[67]

Top-heavy

The top-heavy rules apply to SEPs.[68] The top-heavy ratio is based on the SEP contributions made by the employer, rather than the value of the SEP IRA.[69]

If You're Curious . . .

SEP Documentation

The IRS has issued a model SEP document (Form 5305-SEP) that may be used by an employer that does not currently maintain a qualified plan. Financial organizations or other proper sponsoring organizations may also sponsor a prototype SEP document. The document may also be individually designed, although there is no determination letter procedure to ensure that the document satisfies all requirements. If the plan sponsor wants that type of reassurance, it may apply for a private letter ruling.

The SEP document must be signed by not later than the tax return due date (including extensions) for the year for which the first contribution is made (and for which the employer is taking a tax deduction).[70]

Form 5500 Filings

Generally, a SEP is exempted from filing Form 5500. To qualify for the exemption, the SEP sponsor that adopted the SEP using Form 5305-SEP must:

- provide a new participant with a copy of the Form 5305-SEP at the time that he or she becomes eligible for the plan, including the completed Contribution Agreement, the General Information and Guidelines and the Questions and Answers;
- notify each SEP participant in writing at the end of each year of the amount contributed to his or her IRA made under the Contribution Agreement; and
- if the employer selects, recommends or influences the participant to choose a particular IRA or type of IRA product into which the SEP contributions are made, and if that IRA is subject to restrictions on a participant's ability to withdraw funds (other than restrictions imposed by the IRC that apply to all IRAs), the administrator of the SEP must give to each employee

[66] IRC §408(k)(6)(H).
[67] IRC §§408(a)(4), 408(b)(4).
[68] IRC §408(a)(4).
[69] Treas. Reg. §1.416-1, T-8.
[70] Prop. Treas. Reg. §1.408-7(b).

a written notice when he or she becomes eligible to participate in the SEP explaining those restrictions and a statement to the effect that other IRAs into which rollovers or employee contributions may be made, may not be subject to such restrictions.[71]

If the plan sponsor established the SEP using a document other than Form 5305-SEP, a similar but more detailed collection of notices must be provided to the employees.[72]

If these rules are not satisfied, a Form 5500 must be filed.

SIMPLE IRA PLANS

SIMPLE stands for Savings Incentive Match Plan for Employees. A **SIMPLE IRA** is an arrangement adopted by an employer that satisfies the requirements of IRC §408(p). Eligible employees under a SIMPLE IRA may elect to make contributions to the plan similar to elective contributions to a 401(k) plan. However, the contributions are made to an IRA, similar to a SEP situation, rather than to a qualified plan. Furthermore, based on employer contributions to the SIMPLE IRA, the plan is deemed to pass nondiscrimination tests that would otherwise apply to a SEP IRA or a 401(k) plan.

Eligible Employers

An employer may maintain a SIMPLE IRA plan for a calendar year only if it has 100 or fewer employees earning at least $5,000 of compensation for the prior calendar year.[73] To determine which employees have sufficient compensation, Forms W-2 for the prior year are used. All employees who were employed at any time during the prior calendar year are taken into account for purposes of this requirement, regardless of whether they are excludable from the SIMPLE IRA.[74]

Self-employed individuals, such as sole proprietors or partners, are considered to be employees for purposes of SIMPLE IRA participation (and for the 100-employee count).[75]

If an employer becomes ineligible to maintain a SIMPLE IRA plan because the number of employees who received at least $5,000 of compensation in the prior year is above 100, the law permits a two-year grace period during which the employer may continue the SIMPLE IRA plan.[76] The grace period consists of the two calendar years that follow the last calendar year in which the employer was eligible to maintain a plan under the 100-employee test.

EXAMPLE 2-8. Grace Period Under SIMPLE IRA Plan. The following number of employees received at least $5,000 of compensation in the year indicated:

Year	Number of Employees
2014	60
2015	82
2016	105
2017	120
2018	115

The employer may establish a SIMPLE IRA for 2016 because in the prior year (2015), the number of employees was not more than 100. The last year the employer satisfied the 100-employee test is 2017, because the number is based on the prior year employee information (2018).

[71] DOL Reg. §2520.104-48.
[72] DOL Reg. §2520.104-49.
[73] IRC §408(p)(2)(C)(I).
[74] IRS Notice 98-4, Q&A B-1.
[75] IRC §408(p)(6)(B).
[76] IRC §408(p)(2)(C)(i)(II).

The two-year grace period would permit maintenance of the SIMPLE IRA for the next two years—2017 and 2018. For 2019, the employer would not be able to maintain the SIMPLE IRA, because the employee count in the prior year is above 100. However, if the employee count drops to 100 or less in a later year, a SIMPLE IRA could be maintained for the following calendar year.

Related employers are treated as a single employer. Therefore, the 100-employee test is determined based on all members of a controlled group or affiliated service group that contains the sponsoring employer.

If You're Curious . . .

Exclusive Plan Rule

A SIMPLE IRA may not be maintained for a calendar year if the employees accrue benefits under a qualified plan with respect to services performed for that calendar year.[77]

A qualified plan for this purpose includes all plans that satisfy IRC §401(a) [i.e., profit sharing plans, 401(k) plans, money purchase plans, stock bonus plans, target benefit plans and defined benefit plans], as well as 403(b) plans, 457 plans and SEPs.[78] The exclusive plan rule is not satisfied if any employee who is eligible for the SIMPLE IRA receives an allocation of contributions (in the case of a defined contribution plan) or an increase in his or her accrued benefit (in the case of a defined benefit plan) during a plan year that begins or ends in the calendar year for which the SIMPLE IRA is maintained.

There are two exceptions to the exclusive plan rule, under which contributions could be made to a SIMPLE IRA, even though the company maintains another qualified plan. First, if the qualified plan covers only union employees and the SIMPLE IRA plan excludes union employees, the qualified plan may be maintained. The second exception permits transitional relief for a failure to satisfy the exclusive plan rule because of an acquisition, disposition or merger of companies.

SIMPLE IRA Plan Documents

There are two documents that are relevant to the establishment of a SIMPLE IRA plan: the SIMPLE IRA plan document, which establishes the plan and authorizes the employer to make contributions, and the SIMPLE IRA document, which is the IRA vehicle that accepts contributions on the employee's behalf.

SIMPLE IRA plan document. The IRS has issued two model SIMPLE IRA plan documents. An eligible employer may use Form 5305-SIMPLE to establish a SIMPLE IRA plan that has a designated financial institution—that is, an institution that has agreed to be the place where all the SIMPLE IRAs are established for a given plan. The designated financial institution must also execute the Form 5305-SIMPLE. An eligible employer that does not have a designated financial institution uses Form 5304-SIMPLE.

SIMPLE IRA document. A SIMPLE IRA document is executed by each eligible employee, and establishes the SIMPLE IRA that will receive contributions on behalf of such employee. The IRS has issued two model forms for these documents: Form 5305-S for a trusteed SIMPLE IRA and Form 5305-SA for a custodial account SIMPLE IRA. These SIMPLE IRAs may accept contributions only under the SIMPLE IRA plan.[79]

[77] IRC §408(p)(2)(D).

[78] IRS Notice 98-4, Q&A B-3.

[79] IRC §408(p)(1)(B).

Plan Year

A SIMPLE IRA's plan year must be the calendar year, regardless of the employer's tax year.[80]

Eligible Employees

An employee is eligible to participate in the SIMPLE IRA if he or she satisfies the following requirements:

Past Compensation

The employee must have received at least $5,000 of compensation from the employer in any two prior calendar years. The two years do not have to be consecutive. The $5,000 amount is not subject to cost-of-living adjustments.

Anticipated Compensation

The employee is reasonably expected to receive at least $5,000 of compensation in the calendar year.

The plan may have more expansive eligibility requirements if the sponsor so desires. All employees of a related group who satisfy the eligibility requirements must be permitted to participate in the plan, although the plan may exclude union employees and nonresident aliens.[81]

Opportunity to Defer

An eligible employee must be provided with an opportunity to make elective contributions to the SIMPLE IRA plan. (A sample elective contribution election is provided in both Form 5305-SIMPLE and Form 5304-SIMPLE.)

If You're Curious . . .

The contributions will be deducted from the compensation received by the employee during the calendar year. The employer must provide a minimum election period during which the employee may enter into or modify a contribution election. This election period generally occurs prior to the beginning of the calendar year.

The normal 60-day election period is every November 2 through December 31 (i.e., the 60-day period that ends immediately before the calendar year).[82] If an employee already has an election in effect, he or she may modify it during that period, if desired.

For new SIMPLE IRA plans, the 60-day period must end no later than the day before the effective date of the SIMPLE IRA and must begin no later than the effective date.

When an employee is first eligible during a calendar year, the plan must provide him or her with at least 60 days to enroll for such year. The 60-day period must include either the employee's initial eligibility date or the day before. The employee's elective contributions may not begin before the eligibility date, notwithstanding that the election is complete.

Notice Requirement

Before the beginning of the 60-day election period, the employer must provide the eligible employees with a summary description of the SIMPLE IRA plan and a notice of the employees' rights to make elective contributions or to modify

[80] IRC §408(p)(6)(C).
[81] IRC §408(p)(4)(B); IRS Notice 98-4, Q&A C-1.
[82] IRC §408(p)(5)(C); IRS Notice 98-4, Q&A E-1.

or stop an existing election.[83] A model notice is included in Form 5305-SIMPLE and Form 5304-SIMPLE.

Amount of Elective Deferrals

The elective deferral amount may not exceed an applicable dollar limit for each calendar year. The limit is $12,500 in 2018. The elective deferral may be up to 100 percent of the employee's compensation. Employees who are at least age 50 by the end of the calendar year may also make a catch-up contribution, if desired. The maximum catch-up contribution is $3,000 for 2018. The maximum elective deferral amount and the maximum catch-up contribution may increase with cost of living.

Deposit of SIMPLE IRA Contributions

The employer must deposit the SIMPLE IRA contributions within 30 days of the end of the month for which the contributions are made.[84]

Employer Contributions to SIMPLE IRA

In addition to the employee's elective contributions, the employer must agree to make either an employer matching contribution or a nonelective contribution on behalf of the eligible employees. The contribution obligation applies to all eligible employees, including HCEs. The employer must elect either the employer matching contribution or a nonelective contribution; it cannot elect to make both types of contributions in a given calendar year.

Employer Matching Contribution

If the employer elects the matching contribution option, it must match each employee's elective contribution on a dollar-for-dollar basis up to 3 percent of compensation for the calendar year.[85]

EXAMPLE 2-9. SIMPLE IRA Matching Contribution. Company M maintains a SIMPLE IRA for its employees. Company M elects to make the matching contribution. Mary is an eligible employee with compensation for the calendar year of $29,000. Mary elects to have $1,200 of her compensation deferred to her SIMPLE IRA. Fester is an eligible employee earning $23,000 for the calendar year. Fester elects to have $300 of his compensation deferred to his SIMPLE IRA.

Three percent of Mary's compensation is $870 (.03 x $29,000). Because her elective contribution exceeds this amount, her match is capped at $870. Three percent of Fester's compensation is $690. Because his elective contribution is less than this amount, he receives a matching contribution equal to his elective contribution, or $300.

Some employers may be concerned about making the commitment to contribute the full employer matching contribution in each year, in case it is not affordable in a given year. To accommodate this concern, the IRC permits an employer to elect in up to two of every five years to reduce the maximum employer matching contribution from 3 percent of compensation to 1 percent of compensation.[86]

Nonelective Contribution Option

In lieu of the employer matching contribution alternative the employer may opt to make a nonelective contribution of

[83] IRC §408(l)(2), IRS Notice 98-4, Q&A G-1.
[84] IRC §408(p)(5)(A).
[85] IRC §§408(p)(2)(A)(I) and 408(p)(2)(C)(ii).
[86] IRC §408(p)(2)(C)(ii).

2 percent of compensation to each eligible employee's SIMPLE IRA.[87] The nonelective contribution must be contributed on behalf of each eligible employee who has compensation of at least $5,000 for the calendar year, even if the employee makes no elective contribution for the year and even if the employee is an HCE.

For purposes of both the employer matching contribution maximum and the nonelective contribution, employees' compensation for the entire calendar year is considered, even if the SIMPLE IRA is in effect for less than the full year.

Compensation Limit

The compensation limit of $275,000 (for 2018) applies to SIMPLE IRAs only for purposes of the nonelective contribution. The cap on employer matching contribution of 3 percent of compensation is not subject to the compensation limit.

Vesting

All contributions to SIMPLE IRAs are nonforfeitable.[88]

Deductibility

All contributions to the SIMPLE IRA are deductible by the employer, provided the employer does not contribute more than is permitted under the SIMPLE IRA contribution limits. There is no percentage of compensation limitation for this purpose.

Top-heavy

SIMPLE IRA plans are exempt from top-heavy rules.

Nondiscrimination Testing

SIMPLE IRAs are deemed to be nondiscriminatory. No nondiscrimination testing is required.

Distribution Taxation

Distributions from a SIMPLE IRA are taxable to the employee. If the distribution is made within the first two years of when the employee first participated in the SIMPLE IRA and the participant is under age 59½ when the distribution is made, the 10 percent excise tax under IRC §72(t) is increased to 25 percent.[89] The two-year period is measured from the first date on which a contribution is made to the SIMPLE IRA.[90]

Form 5500 Filing Requirements

A SIMPLE IRA does not have to file a Form 5500.

SIMPLE 401(k) PLANS

IRC §401(k)(11) provides a means of eliminating the nondiscrimination testing for a 401(k) plan by adopting the SIMPLE IRA contribution limits to apply to the 401(k) plan. Under a **SIMPLE 401(k) plan**, the plan will continue to be a qualified plan for all purposes, but will be subject to the SIMPLE IRA contribution rules. For example, all contributions will be made to a 401(k) plan trust, and not to an IRA, on behalf of the participants. Furthermore, the distribution

[87] IRC §408(p)(2)(B).
[88] IRC §408(p)(3).
[89] IRC §72(t)(6).
[90] IRS Notice 98-4, Q&A I-5.

limitations that apply to participants in a 401(k) plan will apply to the funds contributed under a SIMPLE 401(k) plan.

SIMPLE IRA Rules that Apply to a SIMPLE 401(k) Plan

A SIMPLE 401(k) plan will operate just like a SIMPLE IRA for the following purposes:

- The 100-employee test;
- The exclusive plan requirement;
- The lower dollar limitation on elective deferrals and catch-up contributions;
- The notice and election periods;
- The employer contribution requirements;
- The compensation definition for purposes of calculating the cap on employer matching contributions or the amount of nonelective contributions;
- The deemed nondiscriminatory status;
- The nonforfeitability of all contributions;
- The inapplicability of top-heavy rules; and
- The requirement that the plan year be the calendar year.

Differences Between SIMPLE IRA Plans and SIMPLE 401(k) Plans

The following rules are applied differently to SIMPLE 401(k) plans than to SIMPLE IRAs:

- *Eligibility rules*. Normal 401(k) plan eligibility rules apply to the SIMPLE 401(k) plan.
- *Coverage testing*. Because the SIMPLE 401(k) plan is a qualified plan, it is subject to the coverage rules of IRC §410(b). Groups of employees may be excluded from the SIMPLE 401(k) plan if the coverage rules are satisfied.
- *Compensation cap*. The $275,000 (for 2018) limitation on includible compensation under IRC §401(a)(17) applies for both the cap on the employer matching contribution and for purposes of the 2 percent of compensation nonelective contribution.
- *Section 415 limit*. The IRC §415 limitation applies to the SIMPLE 401(k) plan, but not to the SIMPLE IRA.
- *Distribution limitations*. The distribution limitations on elective contributions and qualified nonelective contributions apply to the SIMPLE 401(k) plan, but not to the SIMPLE IRA. The increase in the 10 percent additional income tax on early distributions, for distributions prior to age 59½, does not apply to SIMPLE 401(k) plans, although pre-age 59½ distributions are still subject to the 10 percent penalty.
- *QJSA rules*. If the 401(k) plan containing the SIMPLE is not exempt from the QJSA rules, distributions from the SIMPLE 401(k) accounts will be subject to QJSA waivers and spousal consent.
- *RMDs at age 70½*. The IRA minimum distribution rules apply to a SIMPLE IRA; the qualified plan rules apply to SIMPLE 401(k) plans.
- *Participant loans*. Loans to participants are not permitted in SIMPLE IRAs, but they are permitted in a SIMPLE 401(k) plan.

Form 5500 Filing Requirements

Because a SIMPLE 401(k) plan is a qualified plan, it is subject to the normal Form 5500 filing requirements that apply to other qualified plans.

If You're Curious . . .

403(b) PLANS

A 403(b) plan is a deferred compensation program that is offered to employees of an organization that is tax-exempt under IRC §501(c)(3) or employees of certain educational organizations, and

which satisfies the requirements of IRC §403(b). The operation of a 403(b) plan is similar to that of a 401(k) plan, but §403(b) differs from the IRC section that defines a qualified plan [IRC §401(a)]. While there are many parallel requirements between the two sections, there are intrinsic differences as well.

Contributions under a 403(b) plan must be made to annuity contracts or to custodial accounts investing in mutual funds. Because 403(b) plans originally had to be invested only in annuity contracts, these plans are sometimes referred to as "tax-sheltered annuity" plans.

Comparing 403(b) Plans to Qualified Plans Under IRC §401(a)

The term "qualified plan" does not include a 403(b) plan. Nonetheless, 403(b) plans often are included in the more generic reference to "qualified" employer-sponsored retirement plan arrangements because, like qualified plans, 403(b) plans offer employees a deferral of taxation until actual distribution from the plan and the funding vehicle that holds the assets of the plan is generally tax-exempt.

There are 3 major differences between 403(b) and 401(k) plans:

1. a 403(b) plan is limited to common law employees of certain employers, whereas a 401(k) plan is available to all employers (except State or local governments);
2. 403(b) plans are limited to only certain funding arrangements; and
3. a universal availability rule found in IRC §403(b)(12)(A)(ii) dictates what is needed to be considered nondiscriminatory in relation to elective contributions in a 403(b) plan (i.e., that the elective contribution feature must be made available to virtually everyone in the company, with relatively minor exceptions), whereas a 401(k) plan follows minimum coverage rules under IRC §410(b) and ADP testing under IRC §401(k)(3).

PUERTO RICO PLANS

Puerto Rico plans are plans formed under the laws of the Puerto Rico Internal Revenue Code (PRIRC) for the benefit of employees in Puerto Rico. The PRIRC does not provide the same requirements for "qualified plans" as the U.S. IRC does under IRC §401(a). However, for U.S. tax purposes, the trust forming part of a Puerto Rico plan is exempt from tax under IRC §501(a), in the same manner as the trust funding a qualified plan under IRC §401(a).[91]

ERISA §1022(i)(1) allows a plan created or organized in Puerto Rico to be treated as a qualified plan under IRC §401(a) if:

- the plan administrator makes an election under ERISA §1022(i)(2); and
- the plan otherwise satisfies the requirements of IRC §401(a).[92]

Changes to the PRIRC in 2011 affected retirement plan rules. These rules, which replaced the PRIRC with a new version (generally called the "2011 PRIRC") brought Puerto Rico plans much closer to their U.S. counterparts, but differences remain.

The 2011 PRIRC:

- increased the elective deferral limit to $15,000 effective in 2013, but the U.S. limits apply to dual qualified plans (qualified both under the PRIRC and under the U.S. tax code);
- increased the age 50 catch-up limit from $1,000 to $1,500 effective in 2012;
- adopted controlled group and affiliated service group rules for nondiscrimination testing and

[91] ERISA §1022(i)(1).

[92] Treas. Reg. §1.401(a)-50(a).

made other modifications to the coverage and nondiscrimination testing rules (e.g., a rule similar to IRC §410(b)(6)(C) with respect to merger/acquisition transactions);

- adopted new contribution and benefit limits effective in 2012 that are similar to (but not the same as) IRC §415, with no cost of living adjustments on the dollar limits;
- adopted a compensation dollar limit similar to (but not the same as) IRC §401(a)(17), with no cost of living adjustments except for dual qualified plans;
- modified the HCE definition that is similar to (but not the same as) the definition in IRC §414(q) (dual qualified plans follow the U.S. compensation threshold for HCE determinations);
- modified the tax deduction rules for plan contributions, including an increase for the profit sharing plan deduction limit from 15% to 25% of aggregate participant compensation, and a deduction for the amount contributed to a defined benefit plan that is required to maintain funded status under ERISA; and
- required withholding on certain plan distributions.

The PRIRC does not impose any top heavy requirements, or minimum distribution rules.

The 2011 PRIRC requires a plan to obtain a determination letter in order to be tax qualified. This new requirement went into effect on January 1, 2012. The deadline to apply for a determination letter is the due date (including extensions) for filing the plan sponsor's Puerto Rico income tax return for the first tax year in which the plan began to cover Puerto Rico employees.

Section 2.05: Summary of Plan Types and Features

Type of Plan	Classification	Contribution and Deduction Rules	May Permit Elective Contributions?	Other Features
Defined benefit pension plan	Pension – defined benefit	Contributions fund a definitely determinable benefit that is defined in the plan; subject to minimum funding rules and required to have actuarial certification each year; deduction equal to at least minimum funding amount	No	
Profit sharing plan	Nonpension – defined contribution	Contributions may be stated or discretionary; must have definite allocation formula; deduction limited to 25% of compensation (plus the deduction for elective contributions, if any)	Yes	Most common defined contribution plan
Money purchase pension plan	Pension – defined contribution	Must have a definitely determinable contribution formula; subject to minimum funding; deduction limited to 25% of compensation	No, unless pre-ERISA plan	Significantly less popular since EGTRRA deduction limits increased to 25% for profit sharing plans

Type of Plan	Classification	Contribution and Deduction Rules	May Permit Elective Contributions?	Other Features
Stock bonus plan	Nonpension – defined contribution	Contributions may be stated or discretionary; must have definite allocation formula; deduction limited to 25% of compensation (plus the deduction for elective contributions, if any)	Yes	Required to invest primarily in employer securities and to pay benefits in the form of employer stock unless subject to an exception
Employee stock ownership plan (ESOP)	Nonpension – defined contribution	Contributions may be stated or discretionary; usually allocable proportionate to compensation. Generally subject to 25% deduction limitation, although greater deduction limit applies if plan is leveraged	Yes	Actually a type of stock bonus plan; required to invest primarily in employer securities and to pay benefits in the form of employer stock unless subject to an exception. May borrow from employer or from a third-party lender with employer's guaranty to purchase stock
Target benefit pension plan	Pension – defined contribution	Contributions determined actuarially based on definitely determinable target benefit formula, but limited to DC §415 limits and 25% deduction limit	No	Significantly less popular since new comparability and cross-testing became available
Simplified Employee Pension (SEP)	Nonpension – defined contribution	Contributions are discretionary, but must be allocated proportionate to compensation; deduction limited to 25% of compensation	Yes	IRAs used to fund (no trust); contributions fully vested at all times; special eligibility and distribution rules apply; exempt from 5500 filing requirement
SIMPLE IRA plan	Nonpension – defined contribution	Required matching or nonelective contributions	Yes	IRAs used to fund (no trust); exempt from 5500 filing requirement; only available if there are less than 100 participants; lower elective deferral limits than for 401(k) plans
SIMPLE 401(k) plan	Nonpension – defined contribution	Required matching or nonelective contributions	Yes	Similar to SIMPLE IRA but in 401(k) plan, subject to Form 5500 filing requirements

Section 2.06: Review of Key Concepts

- What is the difference between a defined benefit and a defined contribution plan?
- What are the two categories of employee benefit plans under ERISA?
- What is the difference between a pension and a nonpension plan?
- Identify the different types of defined contribution plans and the eligibility requirements, contribution types, contribution limits, vesting rules, nondiscrimination requirements and Form 5500 requirements for each type of plan.

Section 2.07: For Practice – True or False

1. A pension plan may permit in-service withdrawals prior to age 59½.
2. A SIMPLE IRA plan must have a calendar plan year.
3. A SEP is available only to individuals.
4. Participant loans are permitted in a SIMPLE 401(k) plan.
5. A target benefit plan is a nonpension plan.
6. The employer bears the investment risk in a defined contribution plan.
7. A pension plan must have definitely determinable benefits.
8. A SEP may have a vesting schedule.
9. A 401(k) plan is a nonpension plan.
10. A stock bonus plan may include a 401(k) arrangement.

Section 2.08: Sample Test Questions

1. Which of the following statements regarding types of defined contribution plans is/are TRUE?

    I. An employee bears the investment risk in a defined contribution plan.
    II. A money purchase plan is a nonpension plan.
    III. A stock bonus plan may include a 401(k) component.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

2. Pension plans may permit distributions upon all of the following events, EXCEPT:

    A. Death
    B. Hardship
    C. Disability
    D. Retirement
    E. Termination of employment

3. Which of the following statements regarding types of defined contribution plans is/are TRUE?

    I. A target benefit plan is a defined contribution plan.
    II. An ESOP is designed to invest primarily in employer stock.
    III. A profit sharing plan is a nonpension plan.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

4. All of the following statements regarding profit sharing plans are TRUE, EXCEPT:

    A. An employer is required to have profits to make a profit sharing contribution.
    B. Profit sharing plans are required to have recurring and substantial contributions.
    C. A definite allocation formula is required in a profit sharing plan.
    D. A definite contribution formula is not required in a profit sharing plan.
    E. Nonprofit organizations may adopt a profit sharing plan.

5. Which of the following types of plans are generally required to file Form 5500?

    I. Money purchase plan
    II. SIMPLE 401(k) plan
    III. SEP

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

6. All of the following statements regarding defined contribution plans are TRUE, EXCEPT:

    A. A profit sharing plan may use forfeitures to reduce employer contributions.
    B. A money purchase plan is subject to minimum funding requirements under IRC §412.
    C. A profit sharing plan may be exempt from QJSA requirements.
    D. Employer contributions are discretionary in a SIMPLE 401(k) plan.
    E. A SEP is subject to full and immediate vesting of employer contributions.

7. Which of the following plans is/are considered pension plans?

    I. Money purchase plan
    II. Stock bonus plan
    III. Target benefit plan

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

8. All of the following statements regarding SIMPLE plans are TRUE, EXCEPT:

    A. SIMPLE IRAs may allow for catch-up contributions.
    B. SIMPLE 401(k) plans may allow for catch-up contributions.
    C. SIMPLE IRAs do not have to file a Form 5500.
    D. Participant loans may be available in SIMPLE IRAs.
    E. Participant loans may be available in SIMPLE 401(k) plans.

9. Which of the following statements regarding money purchase plans is/are TRUE?

    I. They must provide a fixed contribution formula
    II. They are required to provide a QJSA as a distribution option
    III. They may not include a 401(k) feature

    A. I only
    B. III only
    C. I and II only
    D. II and III only
    E. I, II and III

10. All of the following statements regarding the differences between pension plans and nonpension plans are TRUE, EXCEPT:

    A. Pension plans may qualify for an exemption from the QJSA rules.
    B. Only nonpension plans may include a 401(k) arrangement.

C. The minimum funding requirements of IRC §412 apply to pension plans.
D. The definitely determinable benefit requirement is applied solely to pension plans.
E. The permissible distribution events are different for pension plans and nonpension plans.

See next page for answers to the true/false and sample test questions.

Section 2.09: Solutions to True or False Questions

1. False. A pension plan may not permit in-service withdrawals prior to age 62..
2. True.
3. False. A SEP is an employer-sponsored plan.
4. True.
5. False. A target benefit plan is a pension plan.
6. False. The employee bears the investment risk in a defined contribution plan.
7. True.
8. False. All contributions to the SEP must be nonforfeitable.
9. True.
10. True.

Section 2.10: Solutions to Sample Test Questions

1. The answer is **C**. A money purchase plan is a defined contribution plan that is classified as a pension plan.
2. The answer is **B**. Pension plans may not permit hardship withdrawals.
3. The answer is **E**. Sll three statements are true.
4. The answer is **A**. An employer is not required to have profits to contribute to a profit sharing plan, unless the plan document requires so expressly.
5. The answer is **C**. A SEP is not required to file Form 5500 if certain conditions are met.
6. The answer is **D**. Employer contributions are mandatory in a SIMPLE 401(k) plan.
7. The answer is **C**. A stock bonus plan is a nonpension plan.
8. The answer is **D**. Participant loans are not permitted in SIMPLE IRAs.
9. The answer is **E**. All of the statements are true.
10. The answer is **A**. Nonpension plans may qualify for an exemption from the QJSA rules. There is no exemption for pension plans.

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Section 3.01: Key Terms

- 12-consecutive-month
- Break in service
- Counting-hours method
- Dual eligibility
- Elapsed time method
- Eligibility computation period
- One-year break-in-service rule
- Period of service
- Period of severance
- Rule of parity
- Service spanning rule
- Statutorily excludable employees
- Statutory age requirement
- Statutory plan entry date
- Statutory service requirement
- Two years of service rule
- Two-year eligibility break-in-service rule
- Year of service

Section 3.02: Introduction

A plan must specify how and when an employee becomes a participant. In other words, what requirements must an employee complete before he or she may enter the plan? ERISA establishes minimum standards relating to age and service requirements for eligibility purposes. The plan's eligibility conditions, however, may go beyond age and service requirements. For example, the plan might exclude certain employees by employment classification (such as hourly paid employees). This chapter discusses the minimum standards for age and service requirements, the exclusion of employees by classification and when an employee becomes a participant after satisfying a plan's eligibility requirements. It also discusses the effect of a break in service on an employee's participation in the plan and the effect of changing the plan's eligibility requirements.

What is the importance of when an employee commences participation? Until the employee becomes a participant, the employee does not accrue benefits under the plan. In a defined contribution plan, this means the employee will not share in any allocation of employer contributions and forfeitures until he or she becomes a participant. If the plan includes a 401(k) arrangement, it also means the employee cannot defer compensation under that arrangement until he or she becomes a participant. In a defined benefit plan, this means the employee will not begin to earn benefits under the plan's accrual formula.

Certain plans are exempt from the minimum age and service rules.[1] These plans include governmental plans and certain church plans. This means that these plans may have eligibility requirements that are more stringent than those permitted in other qualified plans. Nonetheless, these plans may still be qualified plans under IRC §401(a), even though they are exempt from some of the IRC §401(a) requirements.

Section 3.03: Minimum Age and Service Requirements

Most plans require that an employee complete a certain amount of service and attain a given age to enter the plan. However, ERISA and the Internal Revenue Code (IRC) limit how much service an employee must have and how old a person must be before he or she can enter a plan. These are the statutory age and service requirements. If the plan imposes more restrictive age and service requirements for eligibility to participate (that is, a longer service requirement or an older age requirement than the statutory maximums), the plan is in violation of ERISA and the qualification requirements under the IRC.

AGE REQUIREMENT

A plan may not require an employee to reach an age older than 21 as a condition of becoming a participant in the plan.[2]

[1] IRC §410(c)(1)(A) and (B), and ERISA §4(b)(1) and (2).
[2] IRC §410(a)(1)(A)(I); ERISA §202(a)(1)(A)(I).

This is called the **statutory age requirement**. The statutory age requirement is only a minimum standard. The plan may be more liberal by imposing a younger age requirement or by not imposing any age requirement.

If You're Curious . . .

Exception to the Age 21 Requirement

If a plan covers only employees of an educational institution [as defined in IRC §170(b)(1)(A)(ii)] and the employer is a tax-exempt organization, the plan's age requirement may be greater than age 21, but not more than age 26. This exception does not apply unless a participant becomes 100 percent vested after no more than one year of service.[3]

MAXIMUM AGE REQUIREMENT

A plan may not *prohibit* an employee from becoming a participant (or from continuing participation) merely because he or she reaches a certain age.[4] This puts the plan at risk for disqualification and is an age discrimination issue as well.

SERVICE REQUIREMENT

As a general rule, the plan may require no more than one year of service as a condition of becoming a participant in the plan.[5] This is generally referred to as the **statutory service requirement**. The statutory service requirement is only a minimum standard. The plan may be more liberal by imposing a lesser service requirement or by not imposing any service requirement.

Exception to the One Year of Service Requirement

Some plans may increase the requirement to two years to participate in employer contributions if a plan provides for immediate vesting of those contributions.[6] This is called the **two years of service rule**. Immediate vesting means an employee is immediately entitled to 100 percent of the benefits that are allocated to his or her account, regardless of the number of years of service completed. If a plan applies a vesting schedule to its employer contributions, where the percentage of vesting depends on a participant's years of service, the plan may not use this two years of service rule for those contributions.

The 401(k) portion of a plan, under which employees may elect to defer compensation, may not exceed the one year of service requirement under any circumstances.[7] However, a plan that includes a 401(k) arrangement may use the two years of service rule for other portions of the plan, such as the matching contribution portion or the nonelective contribution portion, provided the employees are immediately vested in those contributions. So, for example, a plan that immediately vests its nonelective and matching contributions may require that an employee complete one year of service before making elective contributions, but that she complete two years of service before sharing in the employer's nonelective and/or matching contributions.

PLAN MAY REQUIRE BOTH AGE AND SERVICE CONDITIONS

A plan may impose both an age and a service requirement. In such cases, the employee is considered to satisfy the requirements after the <u>later</u> of the two requirements is satisfied.

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[3] IRC §410(a)(1)(B)(ii); ERISA §202(a)(1)(B)(ii).
[4] IRC §410(a)(2); ERISA §202(a)(2).
[5] IRC §410(a)(1)(A)(ii); ERISA §202(a)(1)(A)(ii).
[6] IRC §410(a)(1)(B)(I); ERISA §202(a)(1)(B)(I); Treas. Reg. §1.410(a)-3T.
[7] IRC §401(k)(2)(D).

EXAMPLE 3-1. Satisfies Service But Not Age. Suppose a plan requires completion of one year of service and attainment of age 21. Stacy is hired at age 18, and completes a year of service in the first 12 months following her employment date. Stacy will not complete the eligibility conditions until after she attains age 21 and satisfies the age requirement.

JOB CATEGORY EXCLUSIONS

An employer may select certain classifications of employees and exclude them from participation in the plan. If these types of exclusions are used, special testing applies under IRC §410(b) to show that the plan satisfies the coverage requirements. These testing rules are discussed in Chapter 6.

Age or Service Conditions Disguised as Job Category Exclusions

An employer is not permitted, either specifically or indirectly, to create a job category for the purpose of excluding participants who have not completed eligibility requirements that exceed the statutory requirements, even if the coverage rules are met when these individuals are excluded. A plan may not impose any eligibility conditions that on the surface appear to be unrelated to age or service, but in reality are age or service conditions that violate the minimum age or service standards provided in the statute.[8]

Exclusion of part-time employees or seasonal employees by category is such an impermissible service condition, if the term "part-time employee" is defined on the basis of a customary work schedule (such as, less than 20 hours per week). This is because the exclusion relates solely to the employee's service.[9] Under the one year of service definition, it is possible that a part-time or seasonal employee could be credited with enough hours of service to earn a year of service. For example, a part-time employee who normally works less than 20 hours of service per week might end up working substantially more hours because of a special project, overtime or busy seasons. If this employee were excluded from the plan solely because of his or her classification as a part-time employee, the plan would be in violation of the minimum service requirements.[10]

A plan may exclude an employee (including a part-time employee) on the basis of some other classification that is not related to service (for example, the plan could exclude hourly paid employees). Again, such a plan must be careful to satisfy the coverage rules under IRC §410(b).

EXAMPLE 3-2. Exclusion by Category. The ZWH Company sponsors a profit sharing plan for its 100 employees. The HR department determines that the loading dock employees do not value the plan. As a result, the profit sharing plan is amended to exclude loading dock employees from participation. As long as the IRC §410(b) coverage rules are met, this exclusion is permissible.

DUAL ELIGIBILITY PROVISIONS

It is possible to design a plan to include different eligibility requirements for different groups of employees, or to have different eligibility requirements for different parts of the plan. This is referred to as **dual eligibility**.

Dual eligibility, although not in violation of the minimum eligibility standards, may create a coverage problem, because coverage is tested using the easiest eligibility requirements to satisfy, and those who satisfy those requirements but are not able to participate are considered to be not benefiting under the test. On a practical basis, this coverage problem usually does not arise if the most restrictive requirements do not exceed one year of service because special testing rules may be used to satisfy coverage under IRC §410(b) in such a circumstance. Coverage is discussed in depth in Chapter 6.

[8] Treas. Reg. §1.410(a)-3(e)(1).
[9] Treas. Reg. §1.410(a)-3(e)(2), Example (3).
[10] TAM 9508003.

New Businesses

When a new business establishes a plan, it may wish to have more liberal entry rules for the current employees than it has for future employees. For example, a corporation formed in a particular year might adopt a plan that is effective in the same year in which the corporation came into existence. That plan might provide that all employees hired by a certain date in that first year (e.g., by December 31 of that year) are eligible immediately so that the start-up employees may enter the plan in the year it is adopted, but future hires are subject to a one year of service requirement.

New Plans

Similarly, when a plan is first established, the employer may wish to include more liberal eligibility rules for the first plan year. For example, a 401(k) plan might allow for an open enrollment in the first year for all employees who are part of the workforce at the time the plan is established, regardless of an employee's length of service with the company, but require a specific service requirement for enrollment after the first plan year.

EXAMPLE 3-3. Special Eligiblity for New Plan. After five years of being in business, the Block and Tackle Company decides to start a profit sharing plan, effective January 1, 2018. The plan will normally require one year of service for participants to be eligible, but the company wants to make sure that anyone employed at the time that the plan is put into effect can participate. Therefore, the plan's eligibility section provides that anyone employed by the company as of the effective date of January 1, 2018 may enter the plan as of that date, but that employees hired after that date must complete one year of service prior to entry. The plan allows for monthly entry dates following completion of the eligibility requirements.

George began working for Block and Tackle on December 1, 2017. John began working for the company on January 3, 2018. Although their hire dates are about a month apart, George is permitted to enter the plan on its effective date of January 1, 2018, while John must wait until the first entry date coincident with or next following his first anniversary, February 1, 2019, before entering the plan.

Plan Amendments

Under an existing plan, the employer might wish to amend the plan to impose more restrictive eligibility rules for future employees, but grandfather in the current employees under the present rules. For example, a plan that started with no service requirement might be amended to impose a one year of service rule. Under the plan, current participants who do not satisfy the one year of service requirement could be permitted to continue participating in the plan.

There is no legal requirement to grandfather the existing participants who do not satisfy the new eligibility requirements. In some cases, the plan amendment will provide that the new conditions apply to the existing participants as well, resulting in the discontinuance of their active participation in the plan if they have not satisfied the amended conditions.

WRITTEN TERMS OF THE PLAN CONTROL

Because the law outlines only the most stringent requirements for eligibility, there are countless combinations of requirements available as options for employers to select for their plans. The written terms of the plan will control and the plan must be administered according to those terms. For example, if the plan document states that the service requirement is one year, the plan administrator cannot decide on an ad hoc basis to apply a more generous six-month wait to employees. Even though the six-month service requirement might be legally permissible, it is not in conformance with the terms of the plan. Failure to follow the terms of the plan is a disqualifying event under the IRC and also is a violation of ERISA. In addition, administering the plan contrary to its terms may result in some employees accruing lesser benefits than those to which the plan entitles them. Therefore, if the employer wants to change the plan's eligibility conditions, it must amend the plan accordingly.

If You're Curious . . .

Improperly Covered Employees

What should a plan administrator do if the plan has inadvertently covered someone who is not eligible to participate? This is an operational error that may be corrected under the IRS' Employee Plans Compliance Resolution System (EPCRS), and generally requires removal of the improper contributions from the employee's account. A discussion of EPCRS is found in Chapter 1.

Improperly Excluded Employees

What should the plan administrator do if the plan has failed to cover an eligible employee as of the time specified in the plan? This also is an error in plan operations that may be corrected under EPCRS, and generally requires missed contributions to be made to the participant's account, along with allocable earnings.

Section 3.04: What Is a Year of Service?

Generally, a year of service is a 12-month eligibility computation period in which an employee is credited with at least 1,000 hours of service.[11] A plan may require *fewer* than 1,000 hours for a year of service, because that is being more liberal than the statutory minimum standard. However, the plan is not permitted to require more than 1,000 hours of service for a year of service.

EXAMPLE 3-4. Year of Service. Company A defines a year of service for plan eligibility purposes as a 12-month period in which an employee performs 750 hours of service. This is permissible as it is less than the statutory minimum of 1,000 hours.

In contrast, Company B defines year of service for plan eligibility purposes as a 12-month period in which an employee performs 2,080 hours of service in an effort to cover only full time employees. This is not permissible as it exceeds the statutory minimum of 1,000 hours.

To determine a year of service, a plan may measure hours by using either a counting-hours method (sometimes called an actual hours method) or an elapsed time method. The plan must specify which method is to be used and the number of hours required for a year of service. These methods are discussed later in this chapter.

ELIGIBILITY COMPUTATION PERIOD

An **eligibility computation period** is the period during which an employee's hours are examined to determine whether a year of service has been completed. The eligibility computation period must be a period of 12 consecutive months. The first eligibility computation period must begin on the employee's employment commencement date.[12] An employee's employment commencement date is the first day for which he or she receives credit for one hour of service. For example, if an employee's employment commencement date is May 18, 2017, the first eligibility computation period runs from May 18, 2017 through May 17, 2018.

Eligibility computation periods after the first such period may be defined as either:

a. the plan year; or
b. 12-month anniversary periods of the initial eligibility computation period.[13]

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[11] IRC §410(a)(3)(A); ERISA §202(a)(3)(A).
[12] DOL Reg. §2530.202-2(a).
[13] DOL Reg. §2530.202-2(b).

The plan must define which method it will use to determine eligibility computation periods after the first period. No other method is acceptable in determining whether the statutory requirements are satisfied.

Shifting to Plan Year

If the plan defines the subsequent periods to be the plan year, the second eligibility computation period begins with the first day of the plan year that begins after the employment commencement date. Thus, there is an overlap between the first and second eligibility computation periods, except in the case where an employee's employment commencement date is the first day of the plan year. Hours of service credited during the overlap count for both periods.[14]

EXAMPLE 3-5. Shifting to Plan Year. Wayne's employment commencement date is August 8, 2017. Therefore, his initial computation period starts August 8, 2017, and ends August 7, 2018. The plan defines subsequent computation periods as the plan year. The plan year is the calendar year.

Wayne's second computation period is the plan year beginning January 1, 2018 (the first day of the plan year beginning after his employment commencement date), and ending December 31, 2018. Therefore, between January 1, 2018, and August 7, 2018, the first and second computation periods overlap. Any hours of service Wayne is credited with during that overlapping period count toward satisfying a year of service for both computation periods.

Following the 2018 plan year, Wayne's computation periods are consecutive, measured on the basis of each succeeding plan year (i.e., the 2019 plan year, the 2020 plan year, and so on).

Anniversary Periods

If the plan defines the subsequent computation periods to be anniversary periods of the initial computation period, the second eligibility computation period will begin on the anniversary of the employee's employment commencement date.[15] Under the anniversary method, the first and second periods will be consecutive and will never overlap.

EXAMPLE 3-6. Anniversary Periods. Assume the same facts as in the prior EXAMPLE 3-5, except that the plan defines subsequent eligibility computation periods as anniversary periods instead of plan years. Wayne's second eligibility computation period would begin August 8, 2018, and end August 7, 2019. There would be no overlap between his first eligibility computation period and his second eligibility computation period. The day after the first period ends, the second one starts. All subsequent eligibility computation periods start on August 8 (that is, the anniversary date of Wayne's employment commencement date).

Unlike the situation that applies when subsequent eligibility computation periods are based on the plan year, the anniversary period method means that each employee will have his or her own eligibility computation period (unless more than one employee is hired on the same day of the year). This is more difficult to administer, and often is the reason why a plan sponsor will choose to shift to the plan year for subsequent eligibility computation periods.

If You're Curious . . .

Effect of a Change in Plan Year on the Eligibility Computation Period

If there is an amendment to the plan year, a short plan year of less than 12 months is created. If an employee's eligibility computation period is measured with reference to the plan year, the eligibility

[14] DOL Reg. §2530.202-2(b)(2).
[15] DOL Reg. 2530.202-2(b)(1).

computation period may not be the short plan year. Instead, the eligibility computation period must run for a full 12 months, even when there is a short plan year. The 12-month computation period beginning on the first day of a short plan year will overlap with the next computation period measured on the basis of the new plan year period.

EXAMPLE 3-7. Short Plan Year. A plan shifts the eligibility computation period to the plan year following an employee's initial computation period. Under its current terms, the plan year ends June 30. Effective January 1, 2018, the employer amends the plan year to a calendar year, creating a short plan year from July 1, 2017, through December 31, 2017.

If the eligibility computation period changes to the plan year, one eligibility computation period runs for the full 12 months from July 1, 2017 (that is, the first day of the plan year that was in progress when the plan year was amended) through June 30, 2018, even though the short plan year ends December 31, 2017, because of the amendment. Another eligibility computation period begins on January 1, 2018 (that is, the first day of the new plan year period) and ends on December 31, 2018, coinciding with the amended plan year period.

The eligibility period that begins July 1, 2017, overlaps for six months with the eligibility period that begins January 1, 2018. Thereafter, subsequent eligibility computation periods will begin on each January 1, coinciding with the new plan year period (that is, January 1, 2019, January 1, 2020, and so on).

Prorated Short Plan Years

A plan may prorate the requirement for a year of service to 500 hours during the short plan year when there is a plan year change, provided it also offers an alternative that credits a year of service to employees who complete at least 1,000 hours of service during the 12-month period beginning with the first day of the plan year that was in progress when the plan was amended. This way, an employee who works at least 500 hours during the short plan year could have his or her eligibility requirements satisfied more quickly, without preventing employees from participating in accordance with the statutory requirements. Remember, the plan may be designed to have eligibility results that are more liberal (that is, more favorable to some or all employees) than the statutory standards, just not less liberal than those standards.

EXAMPLE 3-8. Prorate Short Plan Year. Suppose the plan in the prior EXAMPLE 3-7 provides for a pro-rating of the hours requirement for a year of service during the short plan year running from July 1, 2017, to December 31, 2017. The plan provides that a year of service is credited for that short period if an employee completes at least 500 hours of service (i.e., one-half the normal hours requirement to reflect the six-month length of the eligibility period).

Martha has an erratic work schedule. For the short period, she is credited with only 400 hours. However, from January 1, 2018, through June 30, 2018, she is credited with 620 hours. Accordingly, for the statutory eligibility computation period beginning on July 1, 2017, and ending on June 30, 2018, Martha has completed 1,020 hours and is credited with a year of service. In this way, Martha gets credit for a year of service when she would not have otherwise received such credit if only the short period were considered.

Importance of Subsequent Eligibility Computation Periods

Even in plans that require only one year of service for eligibility, there are several reasons why the second and subsequent eligibility periods may be important. In a one-year eligibility plan, an em-

ployee may not have enough hours of service in the initial period to qualify for participation. The plan needs to define subsequent periods to determine whether the employee becomes a participant in a later year.

If the plan requires two years of service for eligibility, an employee will need at least two eligibility computation periods before he or she can qualify for participation. It is important to note that, if a plan requiring two years of service shifts to a plan year eligibility computation period after the first computation period, the first and second computation periods will overlap, and entry into the plan may be accelerated. If this is not the intended result, it may make more sense for the plan to remain with anniversary date eligibility computation periods.

EXAMPLE 3-9. Employment Anniversary Computation Period. A plan requires two years of service for eligibility purposes. The computation period is the subsequent anniversary year. The plan year is a calendar year. An employee enters the plan on the first January 1 or July 1 that follows completion of the two-year eligibility requirement. Martha commences employment on September 15, 2017. Her first eligibility computation period runs from September 15, 2017 through September 14, 2018. Her second eligibility computation period runs from September 15, 2018 through September 14, 2019. If Martha completes at least 1,000 hours in each of these years, she becomes eligible to participate on September 14, 2019, and actually enters the plan on the following January 1 (that is, January 1, 2020).

EXAMPLE 3-10. Shift to Plan Year Computation Periods. Assuming the same facts as above, except that the computation period shifts to the plan year after the initial eligibility computation period, Martha's second eligibility computation period would be January 1, 2018 through December 31, 2018. If Martha completed her 1,000 hours requirement in both the initial and second years, she would become eligible to participate on December 31, 2018. This would permit her to enter the plan on January 1, 2019, a full year before she would enter under the anniversary period method.

This acceleration in plan entry occurs because of the overlap between the first eligibility computation period and the second—the period from January 1, 2018, through September 14, 2018, counts in both eligibility computation periods. Therefore, it is much easier to be credited with two years of service when subsequent computation periods shift to the plan year.

Eligibility computation periods are also used to measure breaks in service. Under the break-in-service rules (which are discussed later), an employee may lose credit for previously earned years of service, depending on what happens in subsequent eligibility computation periods.

Credit for Earlier Periods

The statutory definition of a year of service looks only at the hours credited during the particular 12-month eligibility computation period. Hours credited for earlier periods are not accumulated. Accordingly, if an employee's hours in either (or both) of the first and second eligibility computation periods are less than the number required by the plan, that employee will fail to satisfy eligibility requirements, even if the hours would be sufficient if added together.

EXAMPLE 3-11. Less Than 1,000 Hours in Eligibility Computation Periods. Florence's employment commencement date is August 1, 2017. She is credited with 70 hours per month. The plan shifts the eligibility computation period to the plan year (which ends every December 31).

Florence's first eligibility computation period runs from August 1, 2017 through July 31, 2018.

During that period, she is credited with only 840 hours which is not enough to earn a year of service. Florence's second eligibility computation period runs from January 1, 2018 through December 31, 2018. During that period, she also is credited with only 840 hours.

Although by December 31, 2018, Florence's cumulative hours from August 1, 2017 through December 31, 2018 total 1,190, she has not earned a year of service for eligibility purposes because she did not complete at least 1,000 hours in a 12-month eligibility computation period.

It is permissible to structure eligibility requirements more liberally so that an employee like Florence would become a participant. For example, the plan could provide for a cumulative hours of service rule, giving an employee credit for a year of service after they have accumulated at least 1,000 hours of service, even if those hours are not completed in a single eligibility computation period. Alternatively, the plan could be written to require fewer than 1,000 hours of service in an eligibility period to earn a year of service.

When a Year of Service Is Credited for Eligibility Purposes

A year of service is credited at the end of the eligibility computation period in which it is earned, even if the hours requirement is met earlier in the year. For example, if the initial eligibility computation period begins on April 10 and ends on April 9 of the following year, the employee receives credit for one year of service as of the April 9 ending date of that eligibility computation period if he or she is credited with at least 1,000 hours of service during that 12-month period. The year of service is credited on the April 9 date, regardless of when the employee might have actually completed the 1,000th hour of service. This rule becomes important in determining the employee's entry date for participation purposes.

EXAMPLE 3-12. Crediting a Year of Service. Marjorie is a full-time employee and works 160 hours per month. She commences employment on May 1, 2017. During November, she actually reaches 1,000 hours of service. Nonetheless, she does not receive credit for a year of service until April 30, 2018, the end of her initial computation period. If the plan provides for entry on the first day of the month following completion of the year of service, Marjorie's entry date is May 1, 2018, because her year of service is considered completed on April 30, 2018, and the plan's entry date system calls for entry on the first day of the month following completion of the year of service.

Remember, the rules discussed in this section are the statutory requirements, which are designed to set minimum standards to protect employees. The plan may be written more liberally, so that a year of service is credited before the end of the eligibility computation period.

EXAMPLE 3-13. Crediting a Year of Service. Suppose that the plan in **EXAMPLE 3-12** is written so that a year of service is credited as of the end of the month in which the 1,000th hour of service is completed during the eligibility computation period. Consequently, Marjorie receives credit for a year of service on November 30, 2017. Using the plan's entry date system described in **EXAMPLE 3-12**, Marjorie's entry date would be accelerated to December 1, 2017, which is the first day of the month following the month in which the 1,000th hour of service is credited. A plan cannot be administered in this fashion unless the terms of the plan expressly provide for this method of crediting a year of service.

The fact that a year of service is not credited until the end of the eligibility computation period does not mean the employee must be employed continuously during that computation period to receive credit for the year. In fact, the employee does not even have to be employed on the last day of the computation period to receive credit for the year of service.

EXAMPLE 3-14. Noncontinuous Service. Janelle's employment commencement date is June 4, 2017. Her initial eligibility computation period ends June 3, 2018. Janelle works until November 10, 2017 and is laid off. On February 2, 2018, she is rehired. Although Janelle is not employed continuously from June

4, 2017 through June 3, 2018, her initial eligibility computation period is still measured on that basis. If she receives credit for at least 1,000 hours of service during her periods of employment in that initial computation period, the plan must credit her with a year of service as of June 3, 2018. The law does not permit the plan to start a new eligibility computation period on February 2, 2018, when Janelle returns, because such approach may fail to give her credit for a year of service on a timely basis.

EXAMPLE 3-15. Seasonal Employees. Corporation X hires seasonal employees. The employees usually work from March through June and from September through December. Steven, a seasonal employee, has an employment commencement date of March 8, 2017. Steven works 550 hours of service through June 28, 2017. Steven recommences employment for the next seasonal period on September 10, 2017, and works through December 20, 2017. During the second period, he receives credit for 480 hours of service. Steven does not recommence employment until March 16, 2018. Steven's initial eligibility computation period runs from March 8, 2017 through March 7, 2018. During that period, Steven completed 1,030 hours of service. The plan must credit Steven with one year of service as of March 7, 2018, even though he is not actually employed on that date.

It is common to see the plan define the eligibility computation period as a 12-consecutive-month period, and then define the year of service as 1,000 or more hours in such period. The use of the phrase **12-consecutive-month** is generally required to clarify that the statutory year of service definition requires the employee to complete all 1,000 hours within 12 months that are consecutive. In other words, if an eligibility computation period starts April 1, then it ends the following March 31, because there are 12 consecutive months that make up that period. It is important to note that "consecutive" does not mean that the employee must be employed continuously during the 12-month period. As long as the employee completes at least 1,000 hours in the designated computation period, a year of service must be credited, even if the employee was not employed for a portion of that period.

COUNTING-HOURS METHOD

Under the **counting-hours method**, an employee will receive credit for a year of service based on having accumulated a given number of hours of service during a specific period of time.

Hours of Service Defined

An employee will receive credit for the hours during which he or she performs services. In addition to actual hours worked, hours must also be credited for certain nonperformance of services, for back pay awards and for time spent on maternity or paternity leave or in active military service.[16]

Hours Credited for Performance of Services

An employee receives credit for each hour of service for which he or she is paid (or entitled to be paid) to perform services.[17]

Counting actual hours may be difficult for employees who are not paid by the hour (such as, salaried employees). In these cases, the employer is responsible for translating an employee's performance of services into an appropriate number of hours. The facts and circumstances of the employment relationship will be relevant here, such as the terms of the employment contract, which might specify the hours worked, and a requirement for the employee to complete time sheets and submit them to the employer. Alternatively, the employer may consider adopting one of the regulatory equivalencies, as described below.[18]

[16] DOL Reg. §2530.200b-2.

[17] DOL Reg. §2530.200b-2(a)(1).

[18] IRS Q&A 28 of session with the Taxation Section of the American Bar Association on May 9, 2003.

Equivalency Methods

The regulations provide shortcuts that may be used to determine an employee's hours of service, rather than counting all hours of service. Equivalencies may be based on working time, periods of employment or earnings. These equivalencies cannot be used unless specified in the plan document.[19]

If You're Curious . . .

Equivalencies Based on Working Time

Under this rule, only hours worked or regular time hours are counted. Hours worked are hours credited for the performance of duties (or back pay awards for performance of duties).[20] When the hours worked equivalency is used, participants who work 870 hours or more must be treated as equivalent to having worked 1,000 hours for purposes of the year of service definition. Regular time hours are hours worked that are not paid at a premium rate. When the regular time hours equivalency is used, an employee who completes 750 hours must be treated as equivalent to someone who works 1,000 hours for purposes of the year of service definition. These rules recognize that fewer hours are being counted, because hours paid for the nonperformance of duties are not being considered. Therefore, the plan is not permitted to require the full statutory standard of 1,000 hours of service for a year of service credit.

Equivalencies Based on Periods of Employment

Under this method, hours are credited based on a unit of time.[21] If the employee would be credited with at least one hour of service during that unit of time, a fixed number of hours is credited for that unit. The units of time that may be used are days, weeks, semimonthly payroll periods and months. The hours credited for these units are ten hours for a day, 45 hours for a week, 95 hours for a semimonthly payroll period and 190 hours for a month. The employee's actual hours that would be credited for that unit of time are not used. For example, if a plan uses the monthly equivalency method, the employee is credited for 190 hours for each month in which he or she would be credited with at least one hour of service, regardless of whether his or her actual hours for the month are less than 190 or more than 190.

Equivalencies Based on Earnings

Under this method, hours are determined on the basis of the employee's hourly rate of earnings for a computation period.[22] For example, if an employee's earnings for a 12-month period equal $15,000, and the employee's hourly rate is $10, the employee is credited with 1,500 hours. If the earnings equivalency is used, 870 hours must be treated as equivalent to 1,000 hours for purposes of the year of service definitions. When an employee is not compensated on an hourly basis (e.g., a monthly or annual salary), the regulations provide rules for translating an employee's earnings into an hourly rate based on a customary work schedule. In such cases, 750 hours must be treated as equivalent to 1,000 hours for purpose of the year of service definition.[23]

Hours Credited for Nonperformance of Services

An employee receives credit for each hour of service for which he or she is paid (or entitled to be paid) for not perform-

[19] DOL Reg. §2530.200b-3(c).
[20] DOL Reg. §2530.200b-3(d).
[21] DOL Reg. §2530.200b-3(e).
[22] DOL Reg. §2530.200b-3(f).
[23] DOL Reg. §2530.200b-3(f)(2).

ing services.[24] Nonperformance of services includes vacation, holiday, illness, incapacity, layoff, jury duty, military duty or leave of absence.

It does not matter whether the employment relationship has terminated when crediting hours of service for a nonperformance period.[25] For example, upon termination, an employee receives payment for two weeks of unused vacation. The payment is made with respect to the two-week period following the employee's last day of work with the company. She must be credited with hours of service for that two-week period of nonperformance of services, even though the employment relationship has terminated. The nonperformance period would be treated as starting on the date of termination. This could affect whether an employee earns enough hours to be credited with a year of service.

There would be a different result if the unused vacation pay related to a prior period for which the employee performed services in lieu of taking vacation. If this were the case, crediting hours for the vacation time would be double-counting hours with respect to the same computation period. As described below, double-counting of hours is not permissible.

If You're Curious . . .

Hours of Service May Be Limited

For continuous nonperformance periods, the plan may limit hours of service credited for such periods to no more than 501 hours.[26] For example, suppose an employee was on a paid sabbatical for six months. Based on the employee's normal work schedule, she would be credited with 950 hours during that six-month period. Under this provision, the hours credited to her for the continuous sabbatical period would be limited to 501 hours. The plan may not apply this rule unless it is specified in the plan document.

Payments Calculated on the Basis of Units of Time

If hours of service relate to the nonperformance of services, the regulations prescribe methods for determining the number of hours that should be credited when payment is calculated on the basis of units of time.[27] In these instances, the number of hours credited is the number of regularly scheduled working hours included in the unit of time for which payment is made. If the employee does not have a regular work schedule, the plan may provide for the calculation of the number of hours to be credited on the basis of a 40-hour work-week or an eight-hour workday. Alternatively, the plan may use any reasonable basis that reflects the average hours worked by the employee, or by other employees in the same job classification.

Payments Not Calculated on the Basis of Units of Time

If the payment is not calculated on the basis of units of time (for example, a lump sum payment is made under a disability insurance plan maintained by the employer), the number of hours credited is equal to the amount of the payment divided by the employee's most recent hourly rate of compensation. If the employee's compensation actually is determined on the basis of an hourly rate, then the employee's most recent hourly rate is used. If the employee is paid a fixed rate for specified periods other than hours (e.g., days, weeks or months), the hourly rate is the most recent rate of compensation for the specified period of time, divided by the number of hours regularly scheduled for the performance of duties during such period of time. The plan may use a 40-hour work-week or an eight-hour workday or it may provide for the calculation on any reasonable basis that reflects the average hours worked by the employee over a representative period of time. If the employee's compensation is

[24] DOL Reg. §2530.200b-2(a)(2).
[25] DOL Reg. §2530.200b-2(a)(2).
[26] DOL Reg. §2530.200b-2(a)(2)(I).
[27] DOL Reg. §2530.200b-2(b).

not based on a fixed rate for a specified period, the hourly rate of compensation is determined as the lowest hourly rate of compensation paid to employees in the same job classification, or, if no employee in the same job classification has an hourly rate, the current minimum wage.

Double Credit

An employee should not receive double credit where he or she is paid for both the performance of duties and for the nonperformance of duties for the same computation period.[28] For example, suppose a company provides for two weeks of paid vacation, but if an employee does not take the vacation, he or she receives a lump sum payment for the value of the unused vacation. If an employee receives the lump sum payment in lieu of taking the vacation, he or she is not credited with hours for that payment because it does not relate to any computation period in which the employee did not perform services. During the time he or she would have taken the vacation, the employee was paid for the performance of duties and was already credited for hours of service for that period.[29]

On Call

Some employers have employees who are on call for a period of time. For example, a doctor might have to be on call for certain weekends. The employer is responsible for determining if this on-call time should be converted into hours of service. If the employee's compensation reflects a requirement to be on call for periods of time, there should be some reasonable credit provided for this time. The compensation practices of the employer with respect to these types of employees need to be analyzed. One possible solution is to treat each day of on-call time as if it were a normal workday, and give credit for the number of hours that would be credited for a normal workday, although under the facts and circumstances, this may be an overstatement of the hours for which the employee is paid or entitled to be paid. As there is no guidance on this issue from the IRS or the DOL, prudent administrative practices need to be used.

Hours crediting with respect to a back-pay award

If back pay is awarded, or agreed to by the employer, the employee receives credit for each hour of service included in the back-pay award. Hours of service under a back-pay award are not credited if the same hours have already been credited to the employee. For example, if the back-pay award relates to an increase in payment for prior hours already credited, no additional hours of service would be credited to the employee.

Maternity and Paternity Leave, FMLA Leave and Military Leave

In certain circumstances, employees on an unpaid maternity or paternity leave and leave under the Family Medical Leave Act (FMLA) will be credited with hours of service. Furthermore, under the Uniformed Services Employment and Re-employment Rights Act of 1994 (USERRA), individuals who leave their employment to enter into active military service may be credited with hours of service while they are gone.

Entitled to be Paid

An hour of service is credited if the employee is paid or entitled to be paid. The entitled-to-be-paid reference is to ensure that an employee will receive proper credit for hours, regardless of whether the employer actually makes payment for those hours.

[28] DOL Reg. §2530.200b-2(b)(3).
[29] PLR 7946099.

If You're Curious . . .

An interesting issue arises when a business owner, or more often, a family member of a business owner, receives no compensation for work performed. Because the hours of service definition refers to payment, the individual may not be entitled to credit for hours of service during such period. This might be an issue, for example, when the spouse of the owner worked for several years with no compensation before being paid for that time. If the individual performed bona fide services for which compensation would have otherwise been paid, it may be reasonable to argue that hours of service may be credited for the periods of no compensation, on the basis that these are hours for which the employee is entitled to be paid.

The employer should proceed with caution, however, because the individuals involved in these situations usually are highly compensated employees. If the hours of service are not really credited for bona fide services, the IRS may find both a violation of the service crediting rules and, in the case of a highly compensated employee, that the grant of service to that individual was discriminatory under IRC §401(a)(4).

Payments for which Service Credit is not Granted

Payments made or due under a plan maintained solely to comply with workers' compensation laws, unemployment compensation laws or disability insurance laws do not have to be counted in determining hours of service.[30] Similarly, payments made solely for medical reimbursement purposes are not taken into account in determining hours of service.

ELAPSED TIME METHOD

Under the **elapsed time method**, hours of service are not counted, and there are no eligibility computation periods to measure. Instead, the plan administrator calculates the employee's period of service, as defined under the elapsed time rules. A **period of service** is the period that begins with the employee's employment commencement date and ends with the date on which the employee experiences a period of severance.

When the period of service equals the length of service required for eligibility, then the employee has satisfied that eligibility requirement. For example, if the eligibility requirement is a year of service, then after 12 months of service the employee receives credit for one year of service. If a plan requires less than a year of service (e.g., three months), the service requirement would be satisfied after the employee has three months of service credited under the elapsed time method.

When an employer uses the elapsed time method, an employee can attain a year of service regardless of the number of hours of service that would have been credited. This may permit more part-time employees to qualify for the plan than the employer intends. If so, the plan should consider using the counting-hours method instead. A part-time employee might be excluded from the plan if, instead of using elapsed time to determine whether an employee satisfies the plan's one year of service eligibility requirement, the plan used the counting-hours method and defined a year of service as 1,000 hours of service in an eligibility computation period as discussed earlier.

EXAMPLE 3-16. Elapsed Time Method for Part-Time Employee. The Johnson Yogurt Company sponsors a profit sharing plan that requires one year of service for eligibility purposes, and credits service on the basis of the elapsed time method.

Eli was employed on March 15, 2017. As of his one-year anniversary of employment, March 14, 2018, he had completed 780 hours of service. Because the plan uses the elapsed time method to determine eligibility, the number of hours worked does not matter. All that is important is that Eli is an employee on the one-year anniversary of his date of hire. Because he is employed on that date, he will enter

[30] DOL Reg. §2530.200b-2(a)(2)(ii).

the plan on the first entry date coinciding with or next following March 14, 2018.

If, on the other hand, the plan required a year of service and used the counting-hours method, Eli will not be eligible to enter the plan as of his first anniversary date because he did not complete 1,000 hours during his first employment year.

Service Spanning Rule

Although elapsed time looks at periods of service, certain absences are disregarded and the employee is deemed to be in service during such periods. Under the **service spanning rule**, absences of less than 12 months, regardless of the reason for the absence, are treated as if the employee was employed during that absence. This rule makes the elapsed time method ineffective in excluding seasonal employees. Seasonal employees might be excluded from the plan if, instead of using elapsed time, the plan defined a year of service as 1,000 hours of service in an eligibility computation period.

EXAMPLE 3-17. Seasonal Employees. Butch is a seasonal employee. He works from May through August and from November through January. During his periods of employment, he is credited with 70 hours per month. Butch's employment commencement date is May 1, 2017. The plan requires a year of service to become a participant, but uses the elapsed time method to credit service.

If we examine Butch's first year of employment, he worked for a total of seven months (May, June, July, August, November and December of 2017, and January of 2018). He is not employed on his one-year anniversary date, and he had several months in the middle of his employment year during which he did not work. As of his one-year anniversary date (April 30, 2018), he is not employed, so it appears at that time that he has not completed one year of service (i.e., his period of service went from May 2017 through January of 2018). Even though he was not working during September and October, this absence was less than one year. Therefore, he is considered to have worked continuously from May 1, 2017 through his severance date of January 31, 2018.

When Butch returns to work on May 1, 2018, his leave of absence (from February 1, 2018, through April 30, 2018) is again less than one year. Therefore, under the service spanning rules, his service is considered to be continuous since May 1, 2017. Now he does have a year of service credit, and will enter the plan as of the entry date next following his May 1, 2018, rehire date (assuming he is still employed at such time).

EXAMPLE 3-18. Comparison to Counting-Hours Method. Suppose the plan in the previous **EXAMPLE 3-17** used the counting-hours method instead of elapsed time and required at least 1,000 hours of service in an eligibility computation period for a year of service. Butch's seasonal employment and his periods of work are the same as in **EXAMPLE 3-17**.

Butch's initial eligibility computation period runs from May 1, 2017 through April 30, 2018. During that period, he is credited with 70 hours in each of the eight months he worked, for a total of 560 hours. Butch would not satisfy the plan's one-year eligibility requirement as of April 30, 2018, as he did in **EXAMPLE 3-17**.

Service Requirement of Less than One Year

One of the most common uses of the elapsed time method is when the service eligibility requirement is less than one year of service. Under the counting-hours method, the plan must define how the service condition will be satisfied without violating the statutory standards of the law. For example, if a plan requires three months of service, and defines months of service as a month in which an employee has at least 80 hours of service, the one year of service rule might be violated. It is possible that an employee with an erratic work schedule could have at least 1,000 hours in an eligibility

computation period (entitled to one year of service credit), but not have at least three months with 80 hours or more in each of those months. To keep the employee out of the plan on the basis of the three-month rule would be a violation of the statutory standards in this case.

Under the elapsed time method, when a plan requires less than one year of service for eligibility there is no minimum hours of service requirement for that period. As a result, there generally is no concern about violating the statutory eligibility requirements. For example, suppose a plan requires three months of service for eligibility, and defines three months of service to mean three calendar months following the employee's employment commencement date, without regard to the number of hours of service credited to the employee for that three-month period. It would be impossible for an employee to satisfy the statutory one year of service requirement without also satisfying the plan's three-month eligibility rule, so the statutory requirement is satisfied.

EXAMPLE 3-19. Service Less Than One Year. Carrie's employment commencement date is July 1. The plan provides for a three-month eligibility condition. A month of service is defined in the plan as at least 100 hours of service in a calendar month.

Carrie is credited with 90 hours of service per month. Her initial eligibility computation period under the statutory standards is measured from her July 1 employment commencement date through the next June 30. During that period, she has 90 hours per month for 12 months, for a total of 1,080 hours. However, she has not completed the plan's eligibility requirement of three months of service because she has not received credit for at least 100 hours in three different calendar months. Failure to make Carrie a participant on the basis of the plan's service condition would be a violation of the statutory minimum service standards.

On the other hand, if the plan used the elapsed-time method of eligibility, Carrie would be considered to complete the eligibility requirements at the end of her third month of employment.

If You're Curious . . .

An employer might want to use a 100-hour-per-month standard for its three-month rule in order to accelerate the entry of its full-time (or substantially full-time) employees. This is legally permissible, so long as there is an alternative to accommodate someone like Carrie in the prior **EXAMPLE 3-19**. For example, the plan could permit entry on the first day of the month following the earlier of (a) three consecutive months of service (defining a month of service as a calendar month in which the employee completed at least 100 hours), or (b) an eligibility computation period in which the employee completes 1,000 hours of service. This approach satisfies the objective of admitting certain employees into the plan more quickly without making it easier for part-time employees to qualify for participation in the plan.

In summary, using a less-than-one-year service requirement may make it more likely for part-time employees to qualify for the plan. The employer should consider this effect in determining whether the plan design is consistent with the employer's objectives in maintaining the qualified plan. If minimizing entry of part-time employees is an objective of the employer, then, while more administratively complex, the counting-hours method with an override for the minimum statutory requirements may be the better option.

Section 3.05: Included Service

All service with the employer must be credited, even service before the plan is established, unless disregarded under the break-in-service rules (discussed below).[31]

[31] IRC §410(a)(5)(A); ERISA §202(b)(1).

SERVICE PRIOR TO PLAN INCEPTION DATE

When an employer first establishes a plan, a current employee already may have completed the minimum service requirement. Unless there are other conditions preventing the employee from becoming a participant, such as an age condition or an employment classification, the employee would become a participant as of the effective date of the plan.

EXAMPLE 3-20. Service Prior to Plan Inception. Tasha's employment commencement date was August 1, 2008. Her employer establishes a new profit sharing plan effective January 1, 2017. The eligibility requirements are one year of service and age 21. As of January 1, 2017, Tasha has already completed a year of service for eligibility purposes. There are no break-in-service rules that apply to Tasha. Tasha's entry date is January 1, 2017 (that is, the effective date of the plan) unless she has not satisfied the age requirement as of such date. The plan cannot disregard Tasha's service before 2017 and require her to earn another year of service in an eligibility computation period that starts on or after January 1, 2017, as a condition for becoming a participant in the plan.

SERVICE WHILE INELIGIBLE

The plan must count all of an employee's service, even if he or she is excluded from the plan by reason of another eligibility condition, such as a minimum age requirement or a job classification exclusion. For example, if a plan excludes employees under the age of 21, an employee's service before he or she reaches that age is counted toward satisfying the plan's service requirement. Thus, if the plan requires a year of service for eligibility, and the employee has completed that requirement before his or her 21st birthday, the employee does not have to complete another year of service after reaching age 21 to be eligible to participate in the plan. Similarly, if a plan excludes employees by job category (e.g., hourly-paid employees are excluded) an employee's service earned while he or she is in that job category must be counted toward eligibility. The plan cannot require the employee to complete another year of service for eligibility purposes after he or she moves to a covered classification if the employee completed a year of service while he or she was a member of the excluded classification.

SERVICE WITH ANOTHER EMPLOYER

Under certain circumstances, an employee's service with another employer may count toward satisfying the eligibility requirements. The information below addresses the crediting of service in several circumstances:

- Service with other companies included in the same related group as the company that maintains the plan;
- Service with a prior employer;
- Service with an employer that is leasing the individual to the company that maintains the plan; and
- Service with unrelated employers who jointly maintain the plan.

Crediting Service with a Related Business

If two or more businesses are treated as a single employer under IRC §§414(b) or (c) (controlled group of businesses), or IRC §414(m) (affiliated service group), all service credited for any member of that related group is treated as service with all members. These IRC sections relate to companies that are owned by other companies (called parents and subsidiaries), that are owned by the same individuals (called brother-sister companies) or who jointly provide services to third parties (called affiliated service groups).

EXAMPLE 3-21. Related Entities. Corporation X is the parent company of Subsidiary Y. Angela works for Subsidiary Y and commenced employment with Y on September 1, 2014. Corporation X

maintains a profit sharing plan. The plan covers only employees of X.

On May 1, 2018, Angela transfers to Corporation X. In determining whether Angela has satisfied the eligibility requirements under X's plan, Angela's service with Subsidiary Y must be counted. X's plan requires a year of service for eligibility and uses the counting-hours method to measure a year of service.

Angela's initial eligibility computation period is measured from September 1, 2014 through August 31, 2015, when she was working for Subsidiary Y. During that time, she was credited with at least 1,000 hours of service. Although she had a year of service as of August 31, 2015, Angela was not eligible for X's plan, because she worked for Subsidiary Y instead of for the parent company. When Angela is transferred to Corporation X on May 1, 2018, she is immediately eligible (unless some eligibility condition other than a year of service has not been satisfied).

When there is a change of ownership (for example, a company buys 100 percent of the stock of another company), a new related group may result. Members of the new related group would be treated as a single employer after the effective date of the ownership change for purposes of these rules.

If You're Curious . . .

Qualified Separate Lines of Business

Some employers or related companies divide their workforces into qualified separate lines of business (QSLOBs), pursuant to IRC §414(r), and are permitted to perform coverage and nondiscrimination testing on each QSLOB as if it were a separate company. The fact that an employer relies on QSLOBs for testing purposes does not affect an employee's right to have service recognized with all QSLOBs. For example, if an employee works for QSLOB-1 and later is transferred to QSLOB-2, his or her prior service with QSLOB-1 must be recognized by QSLOB-2 to determine if any service requirement under QSLOB-2's plan is satisfied.

Crediting Service with a Prior (or Predecessor) Employer

Service is credited with a prior (or predecessor) employer when a new entity is formed to be the successor of a prior company (for example, a corporate successor to a prior partnership) or when one company acquires another company or part of another company (such as the acquisition of a corporate division). A predecessor employer is the entity that previously employed the employees prior to the current company.

If an employer maintains the plan of a prior employer, service with that prior employer must be counted for eligibility purposes. An employer is treated as maintaining a prior employer's plan if it formally adopts that prior plan or if the prior plan is merged into the current employer's plan.[32]

When the current employer is not maintaining the predecessor plan, the decision to credit service with a prior employer is a plan design choice. IRC §414(a)(2) authorizes the Treasury to issue regulations to require the crediting of service with a prior employer. To date, the Treasury has not issued such regulations. Until it does, the only legal requirement is that crediting the service not be discriminatory.[33]

If service with the prior employer is not automatically credited under the plan, then the plan document will have to be amended if the new employer wants to credit service with the prior employer. The amendment must specify the prior employer and the purposes for which service with that prior employer are credited under the new employer's plan.

[32] IRC § 414(a)(1).

[33] Treas. Reg. §1.401(a)(4)-11(d).

If You're Curious . . .

Crediting Service of Leased Employees Under the Recipient Employer's Plan

An individual not directly employed by the plan sponsor is treated as an employee for purposes of crediting service if the individual is a leased employee under IRC §414(n). In that case, the employer receiving that leased employee's services (known as the recipient employer) must credit such services for eligibility purposes under the recipient employer's plan.

An individual is a leased employee if he or she performs services for the recipient on a leased basis for at least a one-year period on a substantially full-time basis. Once the one-year qualifying period is satisfied, hours credited during the one-year qualifying period are counted for eligibility purposes.[34] That means the leased employee's employment commencement date for eligibility purposes is the date he or she first starts performing services on a leased basis. An employee is considered to work for a company on a substantially full-time basis if he or she works for at least (a) 1,500 hours in a 12-month period; or (b) 75 percent of the hours (but no less than 500 hours) customarily worked in that position, whichever is less.[35]

Additionally, for an employee to be leased, the recipient must be paying the actual employer of the individual (called the leasing organization) a fee under an agreement between the parties.[36] This agreement may be very informal, and is not required to be in writing.[37]

The last requirement for someone to be a leased employee is that the employee be under the primary direction and control of the recipient employer.[38] This is a facts and circumstances analysis, based on such factors as:

- when, where and how the individual performs services;
- whether the services are required to be performed by a particular person;
- whether the employee is supervised by the recipient employer; and
- whether the services are performed in the order or sequence outlined by the recipient employer.

It is not relevant whether the recipient employer has the right to hire or fire the individual or if the individual works for others.

EXAMPLE 3-22. Leased Employees. Company Z maintains a profit sharing plan. Susan starts performing services for Z as a leased employee on June 1, 2017. She satisfies the definition of a leased employee with respect to Z as of May 31, 2018. Susan's employment commencement date for eligibility purposes is June 1, 2017. Therefore, Susan has already satisfied a year of service for eligibility purposes as of May 31, 2018, when she is first considered a leased employee of Z for qualification purposes.

If a leased employee was previously employed by the recipient employer on a direct basis, the employee's previous service as a common law employee (that is, a direct employee) of the recipient employer also must be credited for eligibility purposes under the recipient employer's plan. Suppose that, in EXAMPLE 3-22, Susan worked for Z from September 1, 2015 through May 31, 2018. As of June 1, 2018, Susan is transferred to a leasing organization and is leased back to Z. Susan's prior

[34] IRC §414(n)(4)(B).
[35] IRS Notice 84-11, Q&A-7 and IRS Employee Plan News – December 20, 2011 - EPCU Project on Leased Employees.
[36] IRC §414(n)(2)(A).
[37] IRS Notice 84-11, Q&A-6.
[38] IRC §414(n)(2)(c).

service as Z's common law employee is counted for eligibility purposes. Therefore, Susan is already a participant in Z's profit sharing plan. Unless she is excluded for reasons other than the service requirements, such as the age requirement or an employment classification condition (for example, the plan might exclude leased employees by classification), she will continue to participate in Z's plan following her reclassification as a leased employee.

It is permissible for an employer to cover a leased employee in its plan before the employee finishes the one-year qualifying period. IRS Notice 84-11, Q&A-9, provides that a plan will not fail to be qualified merely because the plan covers an individual who would be a leased employee except that he or she has not satisfied the substantially full-time requirement during the one-year qualifying period.

EXAMPLE 3-23. Early Entry by Leased Employee. Company N maintains a 401(k) plan. The plan provides for immediate eligibility (that is, no service requirement). Starting June 1, 2017, Chelsea is leased to Company N. Chelsea does not have any prior service with N as a common law employee. Company N and the leasing company are not part of a related group. Company N's plan permits leased individuals to participate as of their commencement date, even though they will not satisfy the statutory definition of a leased employee until the one-year qualifying period is satisfied. Under this provision, Chelsea is allowed to participate in N's 401(k) plan as of June 1, 2017. A reasonable interpretation of IRS Notice 84-11, Q&A-9, is that such a provision does not disqualify the plan, so long as Chelsea otherwise satisfies the definition of a leased employee.

EXAMPLE 3-24. Overriding Plan Language Regarding Leased Employees. Assume that Company N wants to take a more conservative approach. The plan could instead provide that, at the end of the one-year qualifying period, a leased individual is treated as a leased employee, regardless of whether the individual performed services on a substantially full-time basis, and the immediate entry rule would apply as of the end of the one-year qualifying period. Under this approach, Chelsea's immediate entry would be on May 31, 2018, even if she does not perform substantially full-time services for the 12-month period ending May 31, 2018.

Crediting Service with Unrelated Employers

In some cases, two or more businesses that are not considered related businesses will jointly establish a single plan. These businesses may form a single plan because they are engaged in the same industry, or because there is some common ownership among the businesses (although not enough common ownership to cause the businesses to be related employers). Under these multiple employer plans, service with one participating employer must be counted as service with the other participating employers for eligibility purposes, even though the employers are not related.[39] Although service for eligibility is credited as if the participating employers constitute a single employer, there are many qualification requirements for which the employers are treated as separate, unrelated employers.

EXAMPLE 3-25. Crediting Service With an Unrelated Employer. Corporations A, B and C operate in the same geographic area and are in the same industry. The corporations are not part of a related group. Many of each corporation's employees have at one time worked for the other corporations. The three corporations establish a multiple employer 401(k) plan. Eligibility requirements under the plan are one year of service and age 21. To determine if an employee is eligible for the plan, the one year of service requirement is measured by taking into account the employee's service with any and all of the participating corporations.

[39] IRC §413 and Treas. Reg. §1.413-2.

Section 3.06: When Does the Employee Become a Participant?

Once an employee satisfies the statutory age and service requirements, the law sets a deadline by which the employee must become a participant.

STATUTORY PLAN ENTRY REQUIREMENTS

Unless excluded from the plan for reasons other than age or service, an employee who has completed the statutory age and service requirements must become a participant no later than the statutory plan entry date prescribed by IRC §410(a)(4) and ERISA §202(a)(4). The **statutory plan entry date** is the earlier of:

- the first day of the plan year that begins after the date the employee completes the statutory age and service requirements, *or*
- six months following the date the employee completes the statutory age and service requirements.

The plan may require that the employee be employed on the applicable entry date.[40] However, the plan document must contain language to ensure proper entry if the employee returns to employment after the scheduled entry date.[41]

EXAMPLE 3-26. Year of Service Completed in First Half of Plan Year. Jerald commences employment on June 5, 2017. His initial eligibility computation period used to determine a statutory year of service ends June 4, 2018. The plan year is the calendar year. Jerald completes at least 1,000 hours of service during the computation period and receives credit for a year of service as of June 4, 2018. Jerald is at least 21 years of age, so as of June 4, 2018, he has satisfied the minimum age and service requirements. The next plan year following June 4, 2018 begins January 1, 2019. Six months following June 4, 2018 is December 4, 2018. The earlier of the two dates is December 4, 2018. To satisfy the statutory entry date requirement, Jerald's participation must begin no later than December 4, 2018.

EXAMPLE 3-27. Year of Service Completed in Second Half of Plan Year. Suppose Jennifer is in the same plan as Jerald. However, her employment commencement date is August 11, 2017, so her initial eligibility computation period ends August 10, 2018. The six-month date following completion of the age and service requirements is February 10, 2019. Because the first day of the next plan year (January 1, 2019) is earlier than the six-month date, the plan will satisfy the statutory entry date requirement as long as Jennifer is made a participant no later than January 1, 2019.

EXAMPLE 3-28. Employment Terminates Before End of Eligibility Computation Period. Suppose in **EXAMPLE 3-27** that Jennifer quits on December 1, 2018, and never returns to work with the employer. Although she is credited with a year of service on August 10, 2018, she is not made a participant on the scheduled entry date (January 1, 2019) because she is no longer employed on that date.

EXAMPLE 3-29. New Plan. A new profit sharing plan is established effective January 1, 2017. The only eligibility requirement is one year of service. The corporation sponsoring the plan has been in existence since 1989. Maureen was hired July 15, 2008. She completed at least 1,000 hours of service during her initial eligibility computation period ending July 14, 2009. Her statutory entry date would have been January 1, 2010, had the plan been in existence. Because the plan must count all years of service, including service earned before the effective date of the plan, Maureen must be made a

[40] Treas. Reg. §1.410(a)-4(b)(1).

[41] Rev. Rul. 80-360, 1980-2 C.B. 142.

participant on January 1, 2017, the effective date of the plan. Because there are no other eligibility conditions imposed by the plan, and Maureen has passed her statutory entry date, the plan must treat her as a participant as of its effective date.

Semiannual Entry Dates

Many plans are designed with semiannual entry dates to ensure an employee's participation will never be postponed beyond the statutory entry date. Semiannual entry dates are usually defined as the first day of the plan year and the first day of the seventh month of the plan year. Semiannual entry dates under a calendar year plan would be January 1 and July 1. If the plan year ends September 30, the semiannual entry dates would be October 1 and April 1. Under the semiannual entry date system, the employee becomes a participant on the semiannual entry date next following completion of the age and service requirements.

When an employee completes the age and service requirements in the first half of the plan year, the appropriate semiannual entry date will be the midyear entry date, resulting in earlier participation in most cases than under the statutory entry date requirements. When an employee completes the requirements in the second half of the plan year, the appropriate semiannual entry date will be the first day of the next plan year, the same as under the statutory entry date requirements. This approach admits some employees into the plan sooner than the statutorily required date, but simplifies plan administration by having only two dates on which new participants enter the plan.

If a plan requires less than one year of service or less than age 21, the plan entry date applicable to that employee will be the next semiannual entry date following the date the employee completes the requirements established by the plan.

If we apply semiannual entry dates to the earlier **EXAMPLE 3-26** and **EXAMPLE 3-27**, we get the following results:

EXAMPLE 3-30. Semi-Annual Entry Dates With Year of Service Completed in First Half of the Plan Year. Using the facts from **EXAMPLE 3-26** but semiannual entry dates, Jerald's entry date would be July 1, 2018, because that is the first semiannual entry date following the date Jerald completes the age and service requirements (June 4, 2018).

EXAMPLE 3-31. Semi-Annual Entry Dates With Year of Service Completed in Last Half of the Plan Year. Using the facts from **EXAMPLE 3-27** but semiannual entry dates, Jennifer's entry date is still January 1, 2019, because the first semiannual entry date that follows Jennifer's completion of the age and service requirements (August 10, 2018) is January 1, 2019.

EXAMPLE 3-32. Completion of Age Requirement After Service Requirement. Assume a calendar-year plan has semiannual entry dates, and requires one year of service and attainment of age 21 for eligibility purposes. Dante commences employment on May 5, 2017 and was born on August 18, 1998. In his first eligibility computation period ending May 4, 2018, he completes at least 1,000 hours of service and receives credit for a year of service. Although Dante has completed a year of service as of May 4, 2018, he is not eligible for the plan until after he completes the age requirement on his 21st birthday, August 18, 2019. At that time, Dante will have completed the eligibility requirements and will enter the plan on the next semiannual entry date, or January 1, 2020.

Other Plan Entry Dates

A plan may be designed with any alternative entry date system that satisfies the statutory requirements. Some plans use more frequent entry dates than semiannual, such as quarterly entry dates, monthly entry dates or even daily entry dates. All of these alternatives are permissible because the employee will become a participant no later than the date required

under the statutory entry date rules. A plan can always be more liberal in favor of the employee than the minimum standards. More frequent entry dates are often found in 401(k) plans.

Single Plan Entry Date

One alternative method of plan entry that requires careful administration is a single plan entry date system. Typically a plan with a single entry date system uses the first day of each plan year as the only entry date. When the only entry date is the first day of the plan year following completion of the eligibility requirements, the plan must still ensure that employees enter the plan in compliance with the statutory rules. The single plan entry date may be either the first day of the plan year in which the participant meets the eligibility requirements or the first day of the plan year following the attainment of the eligibility requirements. The date used must ensure that statutory requirements are not violated.

EXAMPLE 3-33. Year of Service Completed in First Half of Plan Year. Miranda, age 26, commences employment on February 1, 2017. Her initial eligibility computation period ends January 31, 2018. For the initial period, she completes at least 1,000 hours of service. Under a single plan entry date, Miranda would not become a participant until January 1, 2019. However, under the statutory plan entry requirements, Miranda's entry date must not be later than July 31, 2018, which is the date six months after she completes the age and service requirements. Therefore, a January 1, 2019, entry date would violate the statutory requirements unless the plan permits Miranda to become a participant no later than July 31, 2018.

EXAMPLE 3-34. Year of Service Completed in Second Half of Plan Year. If Miranda had commenced employment in the second half of the plan year, a single entry date would not violate the statutory entry date requirement. If she commences employment September 1, 2017, her initial computation period would end August 31, 2018, when she would receive credit for one year of service. Under the plan's single entry date, she would become a participant on January 1, 2019. This conforms to the statutory plan entry requirement, because it is the first day of the next plan year and that date is earlier than six months after Miranda's completion of the age and service requirements.

Although the single plan entry date does not cause the plan in **EXAMPLE 3-34** to violate the statutory requirements in Miranda's case, the plan still would be disqualified unless it contains a plan entry provision that makes it impossible to violate the statutory requirements under any circumstances.[42]

There are two primary ways to design a plan so that a single plan entry date will not cause the plan to be disqualified:

- reduction in age and service; or
- retroactive plan entry.

If You're Curious . . .

Reduction in age and service. One method of curing the defect in a plan using a single plan entry date is to reduce the age and service requirements by at least six months. In other words, the age condition would not exceed 20½, rather than 21, and the year of service condition would not exceed six months, rather than one year. If the plan provides for immediate vesting, so that the two years of service rule is available, this approach would limit the service condition to one year of service plus six months (or eighteen months).

This method is permissible because the statutory plan entry requirements are based on the assumption the plan's eligibility requirements are the statutory age and service requirements—that is, age 21 and one year of service (two years of service, in the case of a 100 percent immediate vesting plan). As

[42] Rev. Rul. 80-360, 1980-2 C.B. 142.

long as the plan is designed so that the employee's entry date is no later than the statutory entry date that would apply if the plan imposed the statutory age and service conditions, the plan satisfies the legal requirements.

EXAMPLE 3-35. Reduced Age and Service Requirements. A plan's eligibility conditions are six months of service and age 20½. The only plan entry date is January 1 (the first day of the plan year) following the completion of the eligibility conditions. An employee, age 25, commences employment on March 18, 2017. The employee completes the six months requirement on September 17, 2017 and will enter the plan on January 1, 2018.

If the plan had imposed the one year requirement, the employee would have completed the year of service on March 17, 2018 and, under the statutory entry date requirements, the employee would have to become a participant no later than September 17, 2018 (that is, six months after completion of the one year requirement). The plan satisfies the statutory requirements because the plan's entry date of January 1, 2018 is not later than the law requires.

Retroactive Entry. There are two approaches to retroactive entry. One approach is to have all employees become participants on the entry date preceding completion of the age and service requirements. The second approach is for employees to become participants on the entry date nearest the date of completion of the age and service requirements, so that only those participants who complete the age and service requirements in the first half of a plan year are subject to retroactive entry. This approach fits best with a plan that uses a single entry date but imposes the statutory age and service requirements.

EXAMPLE 3-36. Preceding Entry Date. A plan's eligibility conditions are one year of service and age 21. The entry date is January 1 (the first day of the plan year) preceding completion of the eligibility conditions. Laura commences employment March 5, 2017 and completes a year of service on March 4, 2018. Her entry date is retroactive to January 1, 2018. Under the statutory entry date requirements, her entry date had to be no later than September 4, 2018, so the plan satisfies the legal requirements.

EXAMPLE 3-37. Nearest Entry Date. Assume the plan described in EXAMPLE 3-36 uses the nearest entry date approach. Bob commences employment on August 5, 2017. A year of service is completed on August 4, 2018, and Bob enters the plan on the nearest entry date, January 1, 2019. Under this approach, Laura's entry date would be the same as it was in **EXAMPLE 3-36** (January 1, 2018) because January 1, 2018, is closer to March 4, 2018, than to January 1, 2019.

If You're Curious…

An advantage of using one of the retroactive entry methods is the plan may still use the full one year of service requirement (or two years of service, in the case of an immediate vesting plan), making it easier to exclude part-time and seasonal employees who may never satisfy the 1,000-hour requirement in a 12-month eligibility computation period.

However, retroactive entry creates an administrative challenge in a 401(k) arrangement. If an employee becomes a participant on the entry date preceding completion of one year of service, when is the employee allowed to start deferring under the 401(k) arrangement? The IRS has not addressed this issue in regulations. However, logically, a retroactive entry means that an employee is considered to be a participant during a period in which he or she usually is not permitted to defer. This makes passing the nondiscrimination (ADP) test more difficult for the plan. As a result, it is recommended that, at least for the 401(k) portion of the plan, semiannual or more frequent entry dates be used to

permit prospective entry, or the plan include a provision regarding the timing of the elective contributions that overrides the normal retroactive entry provisions of the plan.

Other Eligibility Conditions Not Related to Age and Service

A plan may impose conditions on participation that are not related to age and service.[43] Typically, these conditions may include job classifications (as discussed in detail earlier), employees of related employers not covered by the plan, leased employees and independent contractors. In any of these cases, the plan must demonstrate that it satisfies the coverage requirements under IRC §410(b), as discussed in Chapter 6.

Statutorily Excludable Employees

Certain groups of employees may be excluded from participation in the plan without regard to the coverage rules of IRC §410(b) and are known as **statutorily excludable employees**. Accordingly, they may be excluded from the plan regardless of how large a portion they represent of the employee population at the company. Statutorily excludable employee groups include nonresident aliens with no U.S. income and employees covered by collectively bargained agreements (i.e., union employees), so long as benefits are considered in the collective bargaining process. The plan document must specifically provide for these exclusions.

Entry Dates for Employees Excluded for Reasons Other Than Age or Service

If a plan includes other conditions on eligibility besides age and service, the employee will not become a participant under the statutory entry date rules if, as of the applicable entry date, the employee is excluded from the plan on the basis of one of these other conditions. In cases where other eligibility conditions apply, the plan must include a provision for entry into the plan for such employees when the other conditions are satisfied. In other words, the employee must become a participant by the later of:

- the statutory entry date described in IRC §410(a)(4), or
- the date the employee satisfies the other eligibility conditions (such as, eligible job classification) imposed by the plan.

If the date on which the employee satisfies the other eligibility condition is later than the statutory entry date, the employee must enter the plan no later than that date, even if it is not an otherwise scheduled entry date.

EXAMPLE 3-38. Transfer to Included Class. A plan's eligibility conditions are age 21 and one year of service. The plan also excludes employees who work in Division A as a job category classification. The plan year is the calendar year and the entry dates are semiannual (January 1 and July 1).

Rhonda, age 36, commences employment on August 10, 2017. For her initial eligibility computation period ending August 9, 2018, she completes at least 1,000 hours of service and receives credit for a year of service. Under the statutory entry date requirements, her entry date would be January 1, 2019. However, Rhonda works in Division A and is excluded from the plan on the basis of her job classification.

On February 1, 2021, Rhonda transfers to Division B and now satisfies all the eligibility requirements for the plan. The plan must provide for her immediate entry on February 1, 2021, because her statutory entry date (January 1, 2019) has passed. The plan may not postpone Rhonda's entry to the next entry date (July 1, 2021) following her transfer to Division B because statutory entry date rules are measured with reference to the age and service requirements.

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[43] Treas. Reg. §1.410(a)-3(d).

EXAMPLE 3-39. Transfer to Included Class During Initial Eligibility Period. Suppose in **EXAMPLE 3-38** that Rhonda transfers to Division B on November 1, 2018, rather than on February 1, 2021. The transfer date is prior to her statutory entry date of January 1, 2019. Because Rhonda has satisfied all of the plan's eligibility requirements as of her statutory entry date, she will begin participation in the plan under the normal entry date provisions under the plan and she will become a participant on January 1, 2019 (that is, the semiannual entry date following her completion of the one year of service requirement).

Section 3.07: Termination of Employment and Breaks in Service

When an employee terminates employment, active participation in the plan generally ceases. That means he or she is no longer eligible to defer compensation under a 401(k) arrangement, or to share in the allocation of employer contributions and forfeitures under a defined contribution plan, or to accrue benefits under a defined benefit plan.

What happens if the employee returns to employment? When does the employee re-enter the plan? What is a break in service and how does it affect the employee's re-entry? This section addresses these issues. Issues also arise when an active employee's work schedule falls below a certain level and a break in service is incurred, even though the employee has not terminated employment.

RE-EMPLOYMENT

The plan must include specific provisions that address the participation of employees who are re-employed by the employer.[44] If an employee is re-employed, and the plan does not impose a break-in-service rule, then the employee will re-enter the plan on the date of re-employment (regardless of the plan's normal entry date system) if the employee had already satisfied the eligibility requirements and his or her original statutory entry date has passed. If the employee had previously satisfied the eligibility requirements but his or her original plan entry date has not yet passed, that employee will enter the plan on that original date. Finally, if the employee had not satisfied the eligibility requirements before termination, the employee will first have to finish completing those requirements before becoming a participant in the plan.

EXAMPLE 3-40. Re-Employment and Re-Entry Into the Plan. The Green Pine Lumber Company found itself short of labor, so it rehired four people on March 1, 2018 who had worked for it before but had terminated employment. Below are the applicable employees' dates of hire, termination and rehire.

Employee	Hire Date	Termination Date	Rehire Date
Arthur	07/01/2017	11/30/2017	03/01/2018
Molly	04/15/2015	10/28/2017	03/01/2018
Percy	11/01/2016	12/05/2017	03/01/2018
Charlie	01/15/2017	01/31/2018	03/01/2018

The profit sharing plan sponsored by the Green Pine Lumber Company, which operates on a calendar year basis, requires one year of service (defining a year of service to be an eligibility computation period during which an employee completes at least 1,000 hours) and has semi-annual entry dates.

Arthur had completed only five months of service when he terminated employment on November 30, 2017. He must complete his one-year requirement before being eligible to enter the plan.

[44] Rev. Rul. 80-360, 1980-1 C.B. 142.

Molly completed two years of eligibility service before she terminated employment and had entered the plan on July 1, 2016 after she met the requirements. She becomes a participant again immediately upon her return to service.

Percy completed his eligibility requirements on October 31, 2017 but terminated employment prior to his entry date of January 1, 2018. Therefore, he enters the plan immediately upon his return.

Charlie completed his eligibility requirements on January 14, 2018 and was due to enter the plan on July 1, 2018, when he terminated employment. Upon his rehire, he retains his service credit, and will enter the plan on the originally scheduled July 1, 2018 date.

Change in Eligibility Conditions

If the eligibility conditions were amended during the employee's absence, and an employee who satisfied the prior eligibility conditions has not satisfied the amended eligibility requirements, the rehired employee will have to complete the new eligibility requirements before re-entering the plan, unless there is a plan provision grandfathering the individual as a participant.

BREAK IN SERVICE

Qualified plans may include break-in-service provisions. In contrast to eligibility and plan entry provisions that are required to be included in a plan, break-in-service provisions are optional.

If the plan imposes a break-in-service rule, the administrator must determine if the employee has had a break in service and, if so, what effect the break in service has on the employee's re-entry (or initial entry, if not a participant prior to leaving). The phrase, "break in service," is not synonymous with an interruption of service. A break in service is a defined term under the law. How a break in service is determined depends on whether the plan uses the counting-hours method or the elapsed time method to determine service for eligibility purposes.

Break in Service Under the Counting-Hours Method

When a plan uses the counting-hours method, a break in service is determined on the basis of hours of service credited in an eligibility computation period. An employee incurs a **break in service** for eligibility purposes if he or she is credited with 500 or fewer hours of service during an eligibility computation period.[45]

The 500-hour rule is a minimum standard. The plan may be more liberal by defining a break in service using a lesser hours of service rule (for example, defining a break in service as fewer than 250 hours of service in an eligibility computation period), or by not imposing a break-in-service rule. The plan may not be more restrictive by defining a break in service using a greater number of service hours (for example, defining a break in service as 650 hours of service in an eligibility computation period).

Break in Service Under Elapsed Time Method

If the plan uses the elapsed time method to determine service for eligibility purposes, the break-in-service rules apply on the basis of whether the employee has incurred at least a one-year period of severance.[46]

A **period of severance** begins on the participant's severance from service date. If the participant terminates, retires, dies or becomes disabled, the severance from service date is the date on which that event occurs. If the participant leaves the company for another reason, such as sick leave, layoff or leave of absence, the severance from service date is the one-year anniversary of the date the absence begins. A period of severance begins on the severance from service date

[45] DOL Reg. §2530.200b-4.
[46] Treas. Reg. §1.410(a)-7(c)(4).

and ends on the date the employee is re-employed by the company. If the period of severance lasts at least 12 months, a break in service has occurred.

Leave of Absence Exceptions

The law requires service to be credited for absences due to maternity and paternity leave and for leave under the Family and Medical Leave Act.

Maternity/Paternity Leave Rule

If an employee is on an unpaid leave of absence due to maternity or paternity reasons, the plan must credit the employee with hours of service during that absence (up to a maximum of 501 hours). The credit for hours of service under this rule is solely for determining whether the employee has incurred a break in service. These hours do not have to be counted toward a year of service. The maternity/paternity leave rule relates only to unpaid hours because paid hours are required to be credited under the normal hours of service definition.

If the plan uses the elapsed time method of crediting service, a severance of service does not occur until the second (rather than the first) anniversary of the first day of absence by reason of maternity or paternity leave. The period between the first and second anniversaries of the first day of such absence is neither a period of service nor a period of severance.[47]

FMLA Leave

The Family and Medical Leave Act[48] (FMLA) allows employees to take job-protected, unpaid leave for up to 12 work-weeks in any 12-month period if the employee is needed to care for a family member with a serious health condition or because the employee's own serious health condition makes the employee unable to perform the functions of his or her job. Upon return from FMLA leave, an employee's rights with respect to employment benefits, including benefits under pension and other retirement plans, must be restored. Employers with at least 50 employees are subject to this rule.

With respect to the plan, any period of unpaid FMLA leave cannot cause a participant to have a break in service for purposes of eligibility to participate.[49] In this regard, the rule operates in similar fashion to the maternity/paternity leave rule described above. Hours would be credited for an unpaid FMLA leave period for purposes of determining whether the employee has incurred a break in service, but are not credited toward earning a year of service. Because FMLA leave will last for no more than 12 work-weeks in a 12-month period, most employees will have enough service during the applicable eligibility computation period to prevent a break in service even without receiving credit for hours that would have been earned during the FMLA period. Nonetheless, if crediting the employee with hours of service for an unpaid FMLA leave period will prevent a break in service, then the administrator must credit such hours.

If the employee is paid for the FMLA leave period, the normal crediting rules for hours of service apply. Under the normal crediting rules, hours of service during a paid leave period are counted to determine whether an employee has a year of service during an eligibility computation period, as well as whether an employee has a break in service during an eligibility computation period.

Measuring Period for Determining Whether a Break in Service Has Occurred

For eligibility purposes, the plan must use the eligibility computation period to determine whether a break in service has occurred, unless the elapsed time method is used.[50] Therefore, the plan does not begin a new 12-month period starting with the date employment terminates to determine whether a break in service occurs.

[47] Treas. Reg. §1.410(a)-9.
[48] P.L. 103-3.
[49] DOL Reg. §825.215(d)(4).
[50] DOL Reg. §2530.200b-4(a)(2).

A termination of employment is not necessary to incur a break in service. For example, an employee's work schedule may change so that, during an eligibility computation period, the employee is credited with 500 or fewer hours of service. The employee still would have a break in service for that period. If the plan imposes a break-in-service rule, the rule would have the same effect on that employee as it would for a former employee who returns to employment after a break in service.

EXAMPLE 3-41. Reduced Work Schedule Causes Break in Service. Jan is a full-time employee of a corporation that maintains a profit sharing plan. The eligibility computation period shifts to the plan year after the initial eligibility period, the plan year is the calendar year, and the plan uses the counting-hours method. Effective January 1, 2018, Jan begins a reduced work schedule of 20 hours of service per month. For the 2018 plan year, she is credited with only 240 hours of service. Jan has a break in service as of the end of that computation period (i.e., as of December 31, 2018).

Measuring Multiple Breaks in Service

Sometimes the break-in-service rule applies only when the participant has incurred more than one break in service. For example, under the rule of parity (see explained in section [C]2 below), a participant must incur at least five consecutive breaks in service before the rule applies.[51] If the counting-hours method is used, then a participant has five consecutive breaks in service if, for each of five consecutive eligibility computation periods (that is, five plan years in a row or five anniversary periods in a row, depending on how a plan measures the eligibility computation period), the participant was credited with 500 or fewer hours in each of the five periods. If the elapsed time method is used, then a participant has five consecutive breaks in service if he or she has a period of severance that totals 60 or more months.

OPERATION OF THE BREAK-IN-SERVICE RULES

The law provides for the following three applications of the break-in-service rules with respect to the eligibility of rehired employees or of employees who experience a break in service due to reduced hours and then complete sufficient hours in a later year to earn a year of service:

- the one-year break-in-service rule or one-year holdout rule, which determines when an employee's participation resumes following a break in service;
- the rule of parity, which determines when an employee's participation resumes for employees who were 0 percent vested in their employer-provided benefits when their break-in-service periods started; and
- the two-year eligibility break-in-service rule, which applies only under a plan with two-year eligibility and only to an employee who incurs a break in service before completing the two-year service requirement.

One-Year Break-in-Service Rule (One-Year Holdout Rule)

The **one-year break-in-service rule** applies if an employee incurs at least one break in service after a termination of employment. If this occurs, the plan may temporarily disregard the employee's prior service.[52] Prior service means service credited before the break in service. The employee does not receive credit for that prior service until after completing another year of service after rehire. Accordingly, the term one-year holdout rule is sometimes used to refer to this break-in-service rule.

If the plan does not use the one-year break-in-service rule, then the employee's re-entry in the plan is immediate (that is, coincident with the re-employment date following the break in service).

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[51] IRC §410(a)(5)(D).

[52] IRC §410(a)(5)(c); ERISA §202(b)(3).

If You're Curious . . .

The rules for determining whether someone has completed a year of service after returning to employment are the same as those used to determine a year of service under the normal eligibility rules. The first computation period is the 12 months following re-employment.[53] If the employee fails to complete a year of service in that initial 12-month period, the plan measures future periods on the anniversary of the re-employment date or by shifting to the plan year, whichever the plan provides under its normal eligibility computation periods.

If the break in service occurred because of a change in work schedule, rather than because of a termination of employment, the first day of the next eligibility computation period will be treated as the re-employment date. Once the employee completes one year of service after this deemed re-employment date, the plan then must re-credit the prior service as of the first day of the computation period in which the additional year of service is completed. This results in retroactive restoration of the employee's participant status to the first day of that computation period.

When an employee incurs a break in service because of a reduced work schedule, the one-year break-in-service rule results in the employee's participation in the plan being suspended following the break in service until another year of service is earned. The employee's participation resumes as of the first day of the computation period in which an additional year of service is credited, in the same manner as a re-employed employee who incurred a break in service following termination of employment.

EXAMPLE 3-42. Year of Service Earned in First 12 Months Following Re-Employment. Francesca terminates employment on November 5, 2017. She has six years of service with her employer and is a participant in the employer's profit sharing plan. The plan year is the calendar year. The eligibility requirements are age 21 and one year of service. The plan shifts the eligibility computation period to the plan year following the initial period. The plan uses the one-year break-in-service rule to postpone credit for prior service following a break in service.

Francesca returns to employment on May 1, 2020. For the 2018 and 2019 eligibility computation periods, Francesca had zero hours of service, so she has incurred two one-year breaks in service (i.e., one break in service for each eligibility computation period in which she was credited with 500 or fewer hours). Because she has at least one break in service, the one-year break-in-service rule applies. Francesca must complete one year of service before her prior eligibility service is restored.

Francesca's first computation period is the 12 months following re-employment (May 1, 2020, through April 30, 2021). Francesca is credited with 1,600 hours of service during that period. The plan must restore Francesca's prior service as of May 1, 2020 (that is, the first day of the computation period) because she has completed an additional year of service. As a result, Francesca must be retroactively treated as satisfying the eligibility conditions on May 1, 2020 (her date of re-employment), and that is her re-entry date.

EXAMPLE 3-43. Year of Service Not Earned in First 12 Months Following Re-Employment. Suppose that, in **EXAMPLE 3-42**, instead of completing 1,600 hours during her initial eligibility computation period following her re-employment (May 1, 2020, through April 30, 2021), Francesca completes only 800 hours of service during that period. The plan then would shift the computation period to the plan year (the calendar year in this case), beginning with the 2021 calendar year (that is, the plan year that starts in her initial eligibility computation period following her re-employment). Assuming Francesca is credited with at least 1,000 hours of service in

[53] DOL Reg. §2530.200b-4(b).

the 2021 plan year, the plan must restore her prior service as of January 1, 2021 (the first day of that computation period), and she will re-enter as a participant on that date.

EXAMPLE 3-44. Year of Service Never Earned During Period of Re-Employment. Suppose in EXAMPLE 3-43 that Francesca again terminates employment on November 1, 2023. During her period of re-employment she has the following eligibility computation periods: May 1, 2020, through April 30, 2021, January 1 through December 31, 2021, January 1 through December 31, 2022, and January 1 through December 31, 2023. Suppose she does not complete at least 1,000 hours in any of these eligibility computation periods. Thus, Francesca never re-enters the plan during her period of re-employment.

If the plan does not use the one-year break-in-service rule, the fact that Francesca fails to earn another year of service following her return does not prevent her from re-entering the plan. Because she had completed the plan's eligibility requirements before her termination in 2017, she simply re-enters the plan as of her re-employment date on May 1, 2020.

EXAMPLE 3-45. Break in Service Incurred Without Termination of Employment. Marc is a participant in a profit sharing plan. The eligibility computation period shifts to the plan year following the initial computation period and the plan year is the calendar year. The plan uses the one-year break-in-service rule and does not require termination of employment before a break in service can be incurred. Thus, for any eligibility computation period during which an employee has 500 or fewer hours of service, the one-year break-in-service rule means a suspension of participation until another year of service is earned by the employee.

Marc's work schedule is very erratic. He initially satisfied the plan's one year of service eligibility requirement in 2013, and became a participant on January 1, 2014. However, there are plan years when Marc is credited with very few hours of service. A break in service occurs if the hours for any plan year do not exceed 500. For the 2019 plan year, Marc is only credited with 400 hours. As a result, Marc has a break in service as of the last day of that eligibility computation period (i.e., as of December 31, 2019).

Because the plan uses the one-year break-in-service rule, Marc's participation is suspended as of January 1, 2020. He will not resume participation until he completes another year of service. The first computation period for measuring the additional year of service is January 1 through December 31, 2020, because Marc is treated as re-employed as of January 1, 2020, which is the eligibility period that starts after he incurs his break in service on December 31, 2019.

EXAMPLE 3-46. Resumption of Participation. Assume the facts of the previous **EXAMPLE 3-45**. If Marc is credited with 800 hours of service during 2020, he will not resume participation for the 2020 plan year. If, during the 2021 plan year, Marc is credited with 1,100 hours, his participation resumes retroactively to January 1, 2021, because that is the first day of the eligibility computation period in which he completes the additional year of service. Thus, the break in service resulted in one plan year (i.e., the 2020 plan year) in which Marc was not eligible to participate.

EXAMPLE 3-47. Break in Service With No Interruption of Participation. Assume the same facts as in **EXAMPLE 3-46**, but in 2020, Marc completes 1,050 hours, rather than 800 hours. That means he completes a year of service in the year following his break in service, so his participation resumes retroactive to January 1, 2020 and his participation continues uninterrupted.

The one-year break-in-service rule always results in retroactive entry when the employee completes the additional year of service. Retroactive entry can be administratively burdensome. An employee rehired late in the plan year (such as December 1 in a calendar year), may be eligible to re-enter the plan on a retroactive basis and, in the case of a defined contribution plan, share in allocations of employer contributions and forfeitures for that year. The plan administrator, however, may not be able to determine whether he or she is a participant until well after the close of the plan year because of the additional year of service requirement under this rule.

The One-Year Break-in-Service Rule and 401(k) Plans

The IRS has not provided guidance on how the retroactive entry rule should be administered under a 401(k) arrangement. It is possible that the one-year break-in-service rule cannot apply to a 401(k) arrangement because of the impossibility of granting retroactive re-entry in a salary deferral setting. IRS personnel have expressed this view in conferences, although it is unofficial. Under this view, the one-year break-in-service rule could be applied only to the non-401(k) portions of the plan, so that when the employee returns to employment after a break in service, the employee's right to make elective contributions under the 401(k) arrangement resumes immediately upon re-employment, and the one-year break-in-service applies only to re-entry into the non-401(k) portions of the plan.

Another alternative is to allow the participant to defer immediately upon rehire, but if he or she fails to complete 1,000 hours during the first eligibility computation period, the deferrals are refunded as excess allocations to reflect that the employee ended up not regaining the right to participate under the one-year-break-in-service rule. Because of the lack of guidance, it is recommended that the plan document be specific on this issue and that, if the plan specifically applies the one-year break-in-service rule to the 401(k) arrangement to limit the ability of rehired participants to defer immediately upon rehire , the employer should request an IRS determination letter on which it may rely.

The One-Year Break-in-Service Rule in Relation to Two-Year Eligibility Plans

This break-in-service rule may be used by any plan, regardless of whether the eligibility condition is one year of service or two years of service. However, if the eligibility condition is two years of service, the plan would apply this rule only if the break in service occurs after the employee had completed the two years of service requirement. If the break in service occurs before the second year of service is credited, the plan may permanently disregard the prior service.

Rule of Parity

Under the **rule of parity**, the employee loses credit for prior service on a permanent basis following the break-in-service period, if certain conditions are met. As a result, the employee must start over in satisfying the service requirement, as if he or she were a new employee.

For the rule of parity to apply:

- the employee must be a participant when the break-in-service period begins. For this purpose, the employee is a participant if he or she has satisfied the plan's eligibility requirements and has passed the applicable entry date under the plan;
- the employee must incur a minimum of five consecutive breaks in service; and
- the employee must be 0 percent vested in his or her accrued benefit under the plan.[54]

If the plan uses the counting-hours method, an employee has five consecutive breaks in service when, in each of five consecutive eligibility computation periods, the employee is credited with 500 or fewer hours of service. If the plan uses the elapsed time method, an employee has five consecutive breaks in

[54] IRC §410(a)(5)(D); ERISA §202(b)(4).

service when he or she incurs a period of severance that totals 60 months.

Technically, the minimum five-year break requirement described above is the greater of five breaks in service or the number of years of service credited at the time the break-in-service period begins. However, a participant with more than five years of service generally will have at least some vesting under the plan's vesting schedule and the rule of parity would not apply. In most cases, it is correct (and simpler) to think of the rule of parity as applying after a five-year break period.

Once a participant becomes even partially vested, there is no break-in-service rule that will permanently disregard his or her prior service for eligibility purposes. If a partially-vested participant incurs a break in service, the only rule that may apply is the one-year break-in-service rule, under which it is possible to get the prior service recredited.

EXAMPLE 3-48. Rule of Parity. Ron is a participant in his employer's profit sharing plan. When Ron terminates employment on May 10, 2016, he has two years of service and is 0 percent vested in his account balance. The eligibility conditions are age 21 and one year of service. The eligibility computation period shifts to the plan year (the calendar year, in this case) after the initial period. An employee becomes a participant on the semiannual entry date (January 1 or July 1) following completion of these requirements. The 2016 calendar year is Ron's third computation period and, when he terminates employment on May 10, he has completed 600 hours of service for that year. Therefore, Ron does not have a break in service in 2016.

Ron returns to employment on February 10, 2022. For the computation periods that coincide with the 2017, 2018, 2019, 2020 and 2021 plan years, Ron has no hours of service, resulting in five consecutive breaks in service. If the plan uses the rule of parity, Ron is treated as a new employee for eligibility purposes when he is re-employed on February 10, 2022. His initial computation period runs from February 10, 2022, to February 9, 2023. If he completes at least 1,000 hours of service during that computation period, he will become a participant on the next entry date (July 1, 2023). The plan does not have to recredit his prior service and make him a participant retroactively, as under the one-year break-in-service rule discussed above.

EXAMPLE 3-49. Rule of Parity for Elapsed Time Plan. If the plan in this **EXAMPLE 3-48** instead uses the elapsed time alternative to measure eligibility service, Ron's severance from service date is May 10, 2016. He would have a 60-month period of severance as of May 9, 2021. It is on that date that the five-year break in service is incurred. Since Ron does not return until February 10, 2022, the rule of parity would apply. If he is still employed as of February 9, 2023, he has a one-year period of service under the elapsed time method, and his re-entry date would still be July 1, 2023.

Two-Year Eligibility Break-in-Service Rule

If a plan uses the **two-year eligibility break-in-service rule**, it may require that the employee complete both years before incurring a break in service. If the employee has a break in service before completing the second year of service (known as an intervening break in service), the employee loses credit for the prior service and must start again as if he or she were a new employee.[55] If, for a computation period, the employee is credited with more than 500, but fewer than 1,000, hours of service, the employee does not lose credit for the prior service because there is no intervening break in service.

[55] IRC §410(a)(5)(B); ERISA §202(b)(2).

EXAMPLE 3-50. Break in Service After First Year. Denise's employment commencement date is May 15, 2017. Her employer's plan requires two years of service for eligibility purposes. Following the initial eligibility computation period, the plan uses anniversary periods to measure the computation period. An employee becomes a participant on the semiannual entry date (January 1 and July 1, in this case) following completion of the two-year requirement.

For Denise's initial eligibility computation period of May 15, 2017 through May 14, 2018, Denise is credited with at least 1,000 hours of service. Denise terminates employment on September 10, 2018, during her second eligibility computation period, and is credited with only 400 hours during that eligibility computation period. Denise has a break in service during her second eligibility computation period.

Denise returns to employment on October 11, 2019. The plan uses the two-year eligibility break-in-service rule, so Denise is treated as a new employee on her re-employment date, because her break in service was incurred before she had completed the second year of service. The plan begins a new eligibility computation period on the date of Denise's return to employment as if Denise is a brand-new employee.

The initial computation period following her re-employment is October 11, 2019 through October 10, 2020. Denise is credited with at least 1,000 hours of service during that period and is credited with her first year of service because, due to the break-in-service rule, her year of service credited prior to her termination of employment is permanently disregarded. The second period following her re-employment date is October 11, 2020 through October 10, 2021. Denise is credited with her second year of service on October 10, 2021, and becomes a participant on January 1, 2022.

EXAMPLE 3-51. No Intervening Break in Service. Using the same facts as EXAMPLE 3-50, assume that Denise is credited with 850 hours of service, rather than 400 hours, during the second eligibility period (May 15, 2018 through May 14, 2019). In this case, Denise does not have a break in service in the second eligibility computation period and the original anniversary period (i.e., 12-month periods ending every May 14) must continue to be used as her eligibility computation period, and she will retain credit for the first year of service.

Whether Denise earns a year of service for the eligibility computation period May 15, 2019 through May 14, 2020, will depend on how many hours she is credited with between her return on October 11, 2019 and the end of the eligibility computation period (May 14, 2020). If she has at least 1,000 hours of service for the period May 15, 2019, through May 14, 2020, she will receive credit for her second year of service, and her entry date will be July 1, 2020.

Elapsed Time Method

If the plan uses the elapsed time method, this break-in-service rule applies if a one-year period of severance is incurred before the employee's period of service is at least two years (24 months).

Beware of the service spanning rule under the elapsed time method, which credits certain periods of absence as service. Generally, this applies when the employee returns to employment within 12 months of his or her severance date.[56] Under the service spanning rules, a one-year period of severance is not incurred if the employee is re-employed within 12 months of the date of termination.

EXAMPLE 3-52. Service Spanning Rules. Marietta worked for ABC Company, which sponsors a profit sharing plan. The plan requires one year of service for eligibility purposes, and uses the elapsed

[56] Treas. Reg. §1.410(a)-7(a)(3)(vi).

time method. Marietta's date of hire was April 8, 2017. On November 1, 2017, Marietta has a personal emergency out of state, and quits her job with ABC Company. The emergency is resolved faster than she had thought, and Marietta returns to employment with ABC Company on February 3, 2018.

Because of the service spanning rules, any absence from service is not considered to be a period of severance if it is less than 12 months long. Therefore, Marietta is treated for plan purposes as if she was continuously employed from April 8, 2017 to the present.

MILITARY SERVICE

The Uniformed Services Employment and Re-employment Rights Act of 1994 (USERRA)[57] was enacted October 13, 1994, to ensure that employers cannot discriminate against any employee or prospective employee with regard to hiring, retention promotion, or any benefit of employment because of military service.[58]

Eligibility Service Credited Following Re-employment

Under USERRA, if a service member is re-employed by the employer, the eligible period of military service is treated as if it were continuous service with the employer for purposes of determining his or her right to accrue benefits under the plan.

This rule affects eligibility because the re-employed employee cannot be required to complete additional service to requalify for participation under the plan. For example, the one-year break-in-service rule would not apply to postpone plan re-entry because the individual must be treated as if he or she had been continuously employed with the employer during the military service period.[59] In addition, uniformed service required to be credited would count toward the employee's satisfaction of a year of service for eligibility purposes.

Section 3.08: Effect of Changing the Plan's Eligibility Requirements on Current Participants

Just because an employee qualifies as a participant in the plan does not guarantee the employee the right to participate in the plan for the rest of his or her employment with the employer. The right to continue to participate in a plan is not a protected benefit. Accordingly, an employee's status as an active participant in the plan may be affected if the eligibility requirements are modified in a way that the employee is no longer considered to satisfy the requirements for participation. When this happens, the participant's accrued benefit is protected, but the employee will not accrue additional benefits until he or she first re-establishes the right to participate in the plan under the modified eligibility requirements.

AMENDED ELIGIBILITY REQUIREMENTS

One way to affect an employee's continued participation in the plan is to change the service requirement for eligibility. Of course, the modified service requirement must not be more than the statutory service requirements. When the eligibility conditions are amended, the plan may (but is not required to) provide that the existing participants are grandfathered in, meaning that their participation continues even if they cannot satisfy the new eligibility conditions.

EXAMPLE 3-53. Participation Discontinued. A profit sharing plan provides for a six-month eligibility requirement. No minimum hours are required to satisfy the service requirement. A new employee

[57] P.L. 103-353.

[58] IRC §414(u). See also, Rev. Proc. 96-49, 1996-2 C.B. 369, for a model amendment that may be adopted to incorporate §414(u) by reference.

[59] IRC §414(u)(8)(A).

becomes a participant on the monthly plan entry date that is at least six months from the employee's employment commencement date. George is hired on May 1, 2016 as a part-time employee who works only 50 hours per month. Under the six-month rule, he becomes a participant on November 1, 2016.

Effective January 1, 2018, the plan is amended to require a one year of service condition for eligibility and to provide for semiannual entry dates (January 1 and July 1). The year of service is defined to require an employee to complete at least 1,000 hours of service in an eligibility computation period. After the initial eligibility computation period, the eligibility computation period shifts to the plan year (which ends every December 31). The plan does not grandfather in existing participants. According to the plan amendment, to continue participation as of January 1, 2018, a participant must have satisfied the one year of service requirement. If not, the employee's participation is resumed when the one year of service requirement has been satisfied.

George's initial eligibility period was May 1, 2016 through April 30, 2017. Subsequent eligibility periods are the plan year ending each December 31 starting with the plan year that began January 1, 2017. Assuming George has worked only 50 hours a month for his entire period of employment, as of January 1, 2018, he has not satisfied the one year of service requirement, because he does not have an eligibility computation period in which he has completed at least 1,000 hours of service. Thus, George's participation in the plan is discontinued as of January 1, 2018.

EXAMPLE 3-54. Participation Later Reestablished. Suppose George's hours are increased to 90 hours a month as of January 1, 2020. For the eligibility computation period ending December 31, 2020, George completes 1,080 hours, which is enough to receive credit for his first year of service for eligibility purposes. His re-entry date into the plan would be January 1, 2021, which is the entry date that follows his completion of the plan's year of service eligibility requirement.

EXAMPLE 3-55. 401(k) Feature. Suppose the plan described in **EXAMPLE 3-53** and **EXAMPLE 3-54** included a 401(k) arrangement. George's right to make elective contributions under the 401(k) arrangement would cease as of January 1, 2018 and would resume as of January 1, 2021. For the years 2018 through 2020, George would not be considered an eligible employee for purposes of applying the nondiscrimination testing rules to the 401(k) arrangement.

If the plan were to have grandfathered in existing participants in the preceding **EXAMPLE 3-53, EXAMPLE 3-54,** and **EXAMPLE 3-55**, George's participation in the plan would have continued without interruption. When a plan grandfathers in employees, it creates a dual eligibility provision.

The modification of the plan's eligibility service condition will not cause an employee to lose participant status if the employee has already satisfied the new requirement. In the prior **EXAMPLE 3-53, EXAMPLE 3-54,** and **EXAMPLE 3-55**, if George had completed at least 1,000 hours of service in a plan year before January 1, 2018, his participation would have continued after January 1, 2018 because he would have already satisfied the plan's amended eligibility requirement when the amended requirement became effective under the plan.

A change in eligibility requirements may also affect the re-entry of a rehired employee who was formerly a participant in the plan. Unless the amendment grandfathered in former participants, the rehired employee would have to satisfy the new requirements before his or her participation could resume.

ADDITION OF EXCLUSION CLASSIFICATIONS

Another way to eliminate an employee's continued participation in the plan is to add an employment classification exclusion that covers that employee. When employees become ineligible as a result of an employment classification exclusion being added to the plan, it is possible that the plan might not satisfy the coverage requirements under IRC

§410(b). This issue should be analyzed before such an amendment is adopted. Coverage requirements are discussed in depth in Chapter 6.

EXAMPLE 3-56. Plan Excludes Employees in a Particular Division as of a Specified Date. A money purchase pension plan requires a year of service for eligibility purposes. All employees, regardless of job classification, are eligible after they satisfy the service requirement. The plan year ends September 30 and the plan uses semiannual entry dates (October 1 and April 1). Pamela commenced employment on August 1, 2007, was credited with a year of service on July 31, 2008, and became a participant on October 1, 2008.

Effective October 1, 2018, the plan is amended to exclude employees of Division B, including Division B employees who are already participants in the plan. Pamela works in Division B. Her participation in the plan is discontinued as of October 1, 2018. That means she will not receive additional allocations of contributions under the plan after that date.

If the eligibility requirements are changed with a mid-plan year effective date, rather than an effective date at the beginning of the next plan year, the amendment cannot cause a participant to lose his or her right to any benefit accrual to which he or she is already entitled for that plan year. If a participant has already earned the right to accrue the benefit for the plan year in which the eligibility conditions are changed, the elimination of the employee's continued participation in the plan cannot be effective until the next plan year.

If the plan includes a 401(k) arrangement, the participant's right to continue making elective contributions may be eliminated during the year due to a change in the eligibility conditions. However, such elimination cannot take away deferrals already elected at the time the amendment is adopted (or made effective, if later), even if those elective contributions have not actually been deposited to the trust at that time. The employer still would have to deposit the deferrals that were so elected into the plan. In addition, if the participant has already earned the right to matching contributions on those elective contributions, the employer would still have to contribute such matching contributions. However, as of the later of the adoption date or effective date of the amendment, no new elective contributions would be withheld from the employee's compensation.

No Impact on Vesting

If an employee's right to participate is suspended because of a change in the eligibility requirements, the employee will still increase vesting in the benefits already accrued. In other words, years of service earned during the period that participation is suspended are still credited in determining the participant's vested percentage in his or her accrued benefits.

If You're Curious . . .

Still a Participant Under ERISA

An employee who has accrued benefits under the plan as a participant, but who is eliminated from participation because of an amendment to the eligibility requirements, is still a participant for ERISA purposes. Until the employee receives full distribution of his or her benefits, that employee preserves his or her rights under Title I of ERISA that are afforded to plan participants (that is, the right to SPDs, SMMs, employee benefit statements), and may bring a civil action against the plan or the fiduciaries of the plan to enforce Title I of ERISA, as permitted under ERISA §502. In addition, the plan continues to count the employee as a participant for Form 5500 reporting purposes.

Section 3.09: Review of Key Concepts

- What are the eligibility requirements for qualified plans?
- Define a year of service for eligibility purposes.
- Explain the rules regarding eligibility computation periods.
- Determine a participant's plan entry date.
- Define a break in service.
- How do breaks in service affect eligibility determinations?
- What is the effect of a change in eligibility requirements on current participants?

Section 3.10: For Practice – True or False

1. The statutory plan entry date is the earlier of the first day of the next plan year, or six months after satisfying the statutory age and service requirements.
2. An employee incurs a break in service if he or she is credited with 999 or fewer hours during the eligibility computation period.
3. Paid vacation time counts as hours of service for eligibility purposes.
4. An employee's actual hours are not considered under the elapsed time method for crediting service.
5. An employee must be employed on the last day of the eligibility computation period to receive credit for a year of service.
6. Absences of less than 12 months are treated as continuous employment under the elapsed time method for crediting service.
7. Generally, a plan may require a participant to attain age 24 before entering the plan.
8. A 401(k) plan may require two years of service to be eligible for the matching component of the plan.
9. Using less than one year of service for eligibility purposes usually makes it easier for part-time employees to become plan participants.
10. A 401(k) portion of a plan may not require more than one year of service for eligibility.

Section 3.11: Sample Test Questions

1. All of the following statements regarding eligibility requirements are TRUE, EXCEPT:
   A. A plan may permit employees to participate on their date of hire.
   B. A 401(k) plan may require no more than 12 months of service before employees are eligible to make elective contributions.
   C. Quarterly entry dates are required if the plan has a 401(k) component.
   D. A plan may permit employees to participate before they are age 21.
   E. A money purchase plan may require two years of service before employees are eligible to participate.

2. All of the following statements regarding eligibility requirements are TRUE, EXCEPT:
   A. A plan's eligibility provisions may not be amended to exclude a current participant.
   B. A new business establishing a plan may have more liberal eligibility requirements for current employees than for future employees.
   C. A newly established plan may have more liberal eligibility requirements for current employees than for future employees.
   D. A plan may have immediate eligibility for the 401(k) component, but a one year of service requirement for the matching component.
   E. A plan may have a one year of service requirement for the 401(k) component, but require two years of service for the profit sharing component.

3. Based on the following information, determine when Employee A will enter the plan:
   - Employee A is a full-time employee.
   - Employee A's date of birth is December 1, 1996.
   - Employee A's date of hire is March 1, 2016.
   - The plan year is April 1 to March 31.
   - The plan's eligibility requirements are age 21 and one year of service.
   - The plan uses the ERISA statutory entry dates.

   A. March 1, 2017
   B. December 1, 2017
   C. January 1, 2018
   D. April 1, 2018
   E. June 1, 2018

4. All of the following employees may be excluded for eligibility purposes, EXCEPT:
   A. Nonresident aliens with no U.S. income
   B. Employees who have not met the plan's eligibility requirements
   C. Leased employees
   D. Employees classified as part-time
   E. Union employees subject to a collective bargaining agreement

5. All of the following statements regarding break-in-service rules for eligibility purposes are TRUE, EXCEPT:
   A. A plan using the counting-hours method determines breaks in service based on hours credited in the eligibility computation period.
   B. Unpaid FMLA leave cannot cause a participant to incur a break in service.
   C. A plan using the elapsed time method determines breaks in service based on periods of severance.
   D. A retired participant's period of severance begins on the date the participant retires.
   E. A plan using the counting-hours method uses the 12-month period beginning on the day a participant first terminates employment for determining breaks in service.

6. Which of the following statements regarding a break in service for eligibility purposes is/are TRUE?
   I. A break in service may affect the date on which a rehired former participant may re-enter the plan.
   II. A plan is required to impose a break-in-service rule.
   III. A plan may define a break in service to be fewer than 750 hours in an eligibility computation period.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

7. Based on the following information, determine Participant B's date of participation:
   - The plan year is the calendar year.
   - Eligibility is determined using the elapsed time method.
   - The eligibility requirements are attainment of age 21 and one year of service.
   - The plan entry dates are the first day of the month following the satisfaction of the eligibility requirements.
   - Participant B is a full-time employee.

Event	Date
Birth	August 28, 1995
Hire	February 1, 2016
Termination	January 3, 2017
Rehire	March 15, 2017

A. February 1, 2017
B. March 1, 2017
C. March 15, 2017
D. April 1, 2017
E. January 1, 2018

8. Which of the following statements regarding eligibility computation periods is/are TRUE?
   I. The eligibility computation period for a year of service may be less than a 12-month period.
   II. Using the shift to plan year method, there is usually an overlap between the first and second eligibility computation periods.
   III. Using the anniversary method, there is usually an overlap between the first and second eligibility computation periods.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

9. All of the following statements regarding service for eligibility purposes are TRUE, EXCEPT:
   A. A plan must count an employee's service performed prior to meeting the plan's minimum age requirement.
   B. A plan is not required to count an employee's service performed prior to the plan's inception date.
   C. Individuals may be credited with hours of service while on leave during active military duty.
   D. Hours of service may be calculated by actually counting hours or by using equivalencies.
   E. Paid sick time counts as hours of service for eligibility purposes.

10. Which of the following statements regarding the effect of changing a plan's eligibility requirements is/are TRUE?
    I. Existing participants must be allowed to continue participating.
    II. Rehired former participants may need to satisfy the new requirements before re-entry.
    III. A plan is permitted to grandfather in existing participants.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

See next page for answers to the true/false and sample test questions.

Section 3.12: Solutions to True or False Questions

1. True.
2. False. Generally, a break in service is 500 or fewer hours in an eligibility computation period.
3. True.
4. True.
5. False. Although a year of service is not credited until the end of the eligibility computation period, an employee is not required to be employed on the last day of the eligibility computation period to be credited with a year of service.
6. True.
7. False. Qualified plans may not require that a participant attain an age older than 21 as a condition for plan entry, unless they are governmental or electing church plans that are exempt from the minimum age and service requirements.
8. True.
9. True.
10. True.

Section 3.13: Solutions to Sample Test Questions

1. The answer is **C**. Although it is common to allow for quarterly entry dates in a 401(k) plan, it is not a statutory requirement.
2. The answer is **A**. Eligibility requirements are not a protected benefit. A plan amending its eligibility requirements is not required to grandfather employees who have met the pre-amendment eligibility requirements.
3. The answer is **D**. The participant satisfies one year of service on February 28, 2017, and attains age 21 on December 1, 2017. The statutory entry date is the earlier of the first day of the plan year after satisfying the requirements (April 1, 2018) or six months after satisfying the requirements (June 1, 2018).
4. The answer is **D**. A plan cannot exclude part-time employees as a job classification.
5. The answer is **E**. A plan using the counting-hours method must use the eligibility computation period for determining whether a break in service has occurred.
6. The answer is **A**. A plan may impose a break-in-service rule, but it is not required. A plan may define a break in service to be 500 or fewer hours in an eligibility computation period.
7. The answer is **C**. Participant B attains age 21 on August 28, 2016 and satisfies the year of service requirements on January 31, 2017. She would normally enter the plan on February 1, 2017, however, she is not employed on that day. Since she is rehired on March 15, 2017, without incurring a break in service, she enters the plan on that day.
8. The answer is **B**. The eligibility computation period must be a period of 12 consecutive months. Under the anniversary method, the first and second periods will be consecutive and will never overlap.
9. The answer is **B**. A plan must count an employee's service performed prior to the plan's inception date.
10. The answer is **D**. When the eligibility conditions are amended, the plan is not required to allow existing participants to continue participating if they cannot satisfy the new eligibility conditions.

Chapter 4:
Highly Compensated Employees

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Section 4.01: Key Terms

- 5 percent owner test
- Attribution
- Calendar year data election
- Compensation test
- Determination year
- Highly compensated employee (HCE)
- Highly compensated former employee
- IRC §318 attribution
- Lookback year
- Nonhighly compensated employee (NHCE)
- Top-paid group election

Section 4.02: Introduction

Probably the most critical first step of determining anything in qualified plans that has to do with nondiscrimination is differentiating between **highly compensated employees** (HCEs) and **nonhighly compensated employees** (NHCEs). Whether something is discriminatory or not is based on a comparison between these two groups.

HCEs must be identified to apply the various nondiscrimination tests for qualified plans, including the coverage test under Internal Revenue Code (IRC) §410(b), the nondiscrimination test for contributions and benefits under IRC §401(a)(4), the ADP test under IRC §401(k) and the ACP test under IRC §401(m). In addition, a 403(b) plan has to identify HCEs if the plan includes employer matching contributions that are subject to the ACP test, or employer non-elective contributions that are subject to the IRC §401(a)(4) nondiscrimination tests. Employees who are not HCEs are designated as NHCEs for testing purposes.

It is important to note that the determination of HCEs is different than the determination of key employees under the top-heavy rules of IRC §416. The top-heavy rules distinguish between key and non-key employees, rather than HCEs and NHCEs. The top-heavy rules are discussed in Chapter 5.

Determining who is an HCE is more complex than it appears at first blush. This chapter reviews how to properly identify who is and who is not an HCE.

You must go through the following steps to determine HCEs:

- Identify the employer using the controlled group and affiliated service group rules.
- Identify the determination year (the current plan year).
- Identify the lookback year. Take into account whether the calendar year data election is being utilized.
- Identify the employees who are 5 percent owners at any time during the determination year or lookback year using the attribution rules of IRC §318.
- Identify the employees who satisfy the compensation test during the lookback year based on the dollar limit in effect during the lookback year.
- Take into consideration whether the top-paid group election is being utilized by the plan.

Section 4.03: Basic Definition of HCE

An employee is an HCE for a plan year if the employee satisfies one of two tests:

- the 5 percent owner test; or
- the compensation test.[1]

An employee might satisfy both tests, but the employee is an HCE even if he or she satisfies only one of the tests.

[1] IRC §414(q)(1).

RELATED EMPLOYERS

The HCE determination is made on a related group basis. For example, if Corporations X and Y constitute a controlled group of businesses, X and Y do not separately determine their HCEs. Instead, all the employees of both corporations are considered together in identifying HCEs. How the various steps are applied in a related employer situation is discussed further below.

5 PERCENT OWNER TEST

The **5 percent owner test** is satisfied if the employee owns more than 5 percent of the employer (or more than 5 percent of a related employer):

- at any time during the current plan year (known as the **determination year**) or
- during the 12 months preceding the current plan year (known as the **lookback year**).[2]

In other words, if the employee's highest ownership percentage during this two-year period is more than 5 percent, the employee satisfies the 5 percent owner test for the current plan year.

EXAMPLE 4-1. Ownership Interest Greater Than 5 Percent. Liz is an employee of Corporation L. The corporation has only one class of stock. Liz has owned 15 percent of the stock of Corporation L since 1990 and continues to own the stock. Corporation L maintains a profit sharing plan. The plan year is the calendar year. For the current plan year, Liz satisfies the 5 percent owner test and is an HCE because she owns more than 5 percent of Corporation L.

EXAMPLE 4-2. Stock Sold in Lookback Year. On December 1, 2017, Cynthia sells her stock in Corporation P. Her ownership interest at the time is more than 5 percent. She continues to be an employee of Corporation P after the sale of her stock. Corporation P maintains a plan with a plan year ending December 31. For the plan year ending December 31, 2018 (the 2018 plan year), Cynthia is an HCE because she owned more than 5 percent of the corporation for part of the lookback year (January 1 through December 31, 2017). Under the 5 percent owner test, it is only necessary to own more than 5 percent of the employer at any time during either the lookback year or determination year.

EXAMPLE 4-3. No Stock Owned in Current or Prior Year. Continuing with the prior **EXAMPLE 4-2**, when Corporation P determines HCEs for the 2019 plan year, Cynthia will not fall into the 5 percent owner category because, for the determination year (i.e., 2019) and the lookback year (i.e., 2018), she does not own more than 5 percent of the corporation. Cynthia will be an HCE for the 2019 plan year only if she satisfies the compensation test.

EXAMPLE 4-4. No Owners Have an Interest that Exceeds 5 Percent. ProMed, an oncology clinic, is a partnership owned by 40 physicians. None of the physicians owns more than 5 percent of ProMed. There will be no HCEs under the 5 percent owner test. The only HCEs in ProMed will be those who satisfy the compensation test.

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[2] IRC §414(q)(1)(A).

If You're Curious . . .

Ownership

Ownership is determined with reference to the type of organization.[3] For a corporation, ownership is based on the greater of (a) the percentage of the total value of all classes of stock, or (b) the percentage of total voting power for all classes of stock with voting rights. Thus, an employee satisfies the 5 percent owner test if he or she owns more than 5 percent of the total value of all classes of stock or if he or she owns more than 5 percent of the total voting power. Because ownership of more than 5 percent of voting power or value will suffice, if there are two or more classes of stock, it is necessary to examine both the employee's voting ownership and the employee's value ownership to see if either is more than 5 percent to determine if he or she falls into the 5 percent owner category.

For a partnership, ownership means the greater of a percentage of capital interests or profits interests (that is, an individual satisfies the 5 percent owner test if he or she owns more than 5 percent of the capital interests or more than 5 percent of the profits interests in the partnership). Because an individual's capital interest percentage might be different from the individual's profits interest percentage, it is necessary to examine both percentages to see if either is more than 5 percent to determine if the partner falls into the 5 percent owner category.

For a limited liability company or limited liability partnership, ownership is generally referred to as a membership interest. A sole proprietor is the 100 percent owner of the sole proprietorship.

EXAMPLE 4-5. One Class of Stock. Corporation W has one class of stock. All shares have equal voting rights. In this case, separate determinations of voting power and value are not necessary (unless valuation is affected by the holding of certain minority or majority interests) to determine the 5 percent owners. Whitney owns 6 percent of the outstanding shares, which equals 6 percent of the total value and 6 percent of the total voting power. Whitney is a 5 percent owner.

EXAMPLE 4-6. Two Classes of Stock. A corporation has two classes of stock, Class A (1,000 shares at $5 per share) and Class B (100 shares at $10 per share). Only Class A has voting rights.

Charles owns 7 percent of Class A stock (70 shares), and no Class B shares. Tom owns 40 shares of the Class B stock and no shares of Class A stock. The value of Tom's Class B shares equals 6.67 percent of the total combined value of all Class A and Class B shares, determined as follows:

Tom's 40 shares of Class B stock times $10 per share = $400
1,000 total Class A shares at $5 per share = $5,000 worth of Class A shares
100 total Class B shares at $10 per share = $1,000 worth of Class B shares
Tom's $400 / $6,000 combined value of all Class A and Class B shares = 6.67%

It is necessary to examine ownership percentages on the basis of value and on the basis of voting power to make sure all 5 percent owners are identified. Tom is a 5 percent owner, because the value of his stock is more than 5 percent of the total value of all outstanding shares (that is, the combined value of Class A and Class B shares), even though he owns no voting stock.

Charles also is a 5 percent owner because he owns more than 5 percent of the voting shares, even if the value of those shares represents 5 percent or less of the combined value of Class A and Class B shares.

[3] Treas. Reg. §1.414(q)-1T, A-8.

EXAMPLE 4-7. Partnership Interests. Arlene and Don are both partners of Partnership X. Arlene has a 7 percent profits interest, but only a 2 percent capital interest. Don has a 6 percent capital interest, but only a 4 percent profits interest. Both Arlene and Don satisfy the 5 percent owner test, Arlene on the basis of her profits interest and Don on the basis of his capital interest.

Effect of Compensation on 5 Percent Owner Test

No minimum level of compensation is required under the 5 percent owner test. For example, if a 10 percent shareholder receives compensation of $25,000 for a plan year, the 5 percent owner test is still satisfied and that shareholder is an HCE.

EXAMPLE 4-8. Compensation in Prior Year is Less Than Adjusted Dollar Amount Under IRC §414(q)(1)(B). Suppose in **EXAMPLE 4-1** that Liz's compensation from the corporation was $48,000 for the lookback year. Liz is still an HCE for the current plan year, even though her compensation in the lookback year was not more than the amount required to be an HCE under the compensation test, because there is no compensation requirement for the 5 percent owner test. An employee does not have to fall into both HCE categories to be considered an HCE for the plan year.

Ownership in Related Organizations

If there are related organizations, ownership in each corporation is not aggregated to determine if an employee satisfies the 5 percent owner test. For example, if an employee owns two percent of Corporation X and four percent of Corporation Y, the employee does not satisfy the 5 percent owner test. Also, the value and voting power of the stock in the corporations are not aggregated. For example, if an employee owns 8 percent of Corporation X, but no stock in Corporation Y, the employee satisfies the 5 percent owner test, even if the 8 percent ownership interest in Corporation X represents 5 percent or less of the total value or total voting power when both Corporation X stock and Corporation Y stock are considered.

Ownership Attribution

Attribution is the concept of treating a person as owning an interest in a business that is not actually owned by that person. Attribution may be the result of a family relationship or a business relationship.

If You're Curious . . .

The IRC contains three different attribution rules that are referenced in sections that relate to qualified plans: IRC §§267(c), 318 and 1563.

IRC §267 attribution is used in the prohibited transaction rules, IRC § 318 is used to determine attribution from partnerships, estates, trusts, and corporations, and IRC §1563 attribution is used in determining controlled groups of businesses under IRC §414(b) and (c).

IRC §318 attribution is used in determining affiliated service groups, in determining disqualified persons under IRC §409(p) in relation to S corporation ESOPs and in identifying HCEs and key employees.

The IRC §318 attribution rules are written in terms of stock ownership. However, under the qualified plan rules that use IRC §318 attribution, the organization affected by the rules might not be a corporation. If the organization is not a corporation, the IRC §318 attribution rules are applied to a partner's capital or profits interest, in the case of a partnership, a member's ownership interest in a limited liability company or limited liability partnership, or the sole proprietor's interest, in the case of a sole proprietorship. A sole proprietor is treated as the 100 percent owner of his or her business for purposes of attributing to anyone else (such as a family member).

This text uses the generic term "interest" to refer to these various forms of ownership and the following discussion of attribution refers to IRC §318 attribution rules as used for HCE determination.

Family Attribution

An individual is treated as owning any interest that is owned by the individual's spouse, children, grandchildren or parents.[4]

Attribution between spouses. An individual is treated as owning any interest that is owned by that individual's spouse. If the individual and the spouse are legally separated under a decree of divorce or separate maintenance, there is no attribution.

EXAMPLE 4-9. Spousal Attribution. Joe is the 100 percent owner of Corporation T. Joe is married to Lila. Lila is also treated as a 100 percent owner of the corporation.

EXAMPLE 4-10. Family Attribution. Suppose in **EXAMPLE 4-4** that two of the physicians in ProMed are married to each other. One has a 3 percent capital interest in the partnership and the other has a 4 percent capital interest in the partnership. Because the attribution rules of IRC §318 apply, each physician is treated as owning the partnership interest of the other. Therefore, the husband and wife are each treated as 7 percent partners. The two physicians are treated as HCEs under the 5 percent owner test.

The same rule applies if the physicians were not married to each other at the beginning of the lookback year, but got married at any time during the lookback year or the determination year. Likewise, if the physicians were married as of the beginning of the lookback year, but divorce before the end of the determination year, they are HCEs under the 5 percent owner test because for a portion of the relevant testing period they were married and their respective ownership interests were attributed to the other. This is because an individual satisfies the 5 percent owner test if at any time during the lookback year or determination year he or she owns more than 5 percent of the employer, whether by direct ownership or attributed ownership.

If You're Curious . . .

Prior to 2013, only marriages between individuals of the opposite gender were recognized for qualified plan purposes. On June 26, 2013, the Supreme Court, in *U.S. v. Windsor*,[5] ruled that §3 of the federal Defense of Marriage Act (DOMA) is unconstitutional. DOMA §3 states:

> *In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a legal union between one man and one woman as husband and wife, and theword 'spouse' refers only to a person of the opposite sex who is a husband or a wife.*

Because DOMA §3 has been deemed unconstitutional, qualified plans must now treat the relationship of same-gender married couples as a marriage and must treat each party to that marriage as a spouse in order to maintain the plans' tax-qualified status. Federal laws may no longer restrict the terms "spouse" and "marriage" to opposite-gender relationships.

The IRS previously ruled that it will look to applicable state law to determine the marital status of

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[4] IRC §318(a)(1).

[5] 133 S.Ct. 2675 (2013).

individuals.[6] This position has been expanded in rulings that followed the Windsor decision.[7] In particular, if a marriage is performed in a state that recognizes its validity, such marriage will be considered to be valid for federal law purposes, including retirement plans, regardless of whether the couple resides in a state that recognizes the marriage. This is called the "state of celebration" determination. Similarly, legally performed marriages in foreign countries are recognized for federal tax purposes. Accordingly, validly married individuals of the same gender will be considered to be spouses for purposes of applying IRC §318 attribution rules as used for HCE determination and key employee determination as discussed in chapter 5.

Attribution between parents and children. An individual is treated as owning any interest that is owned by the individual's parents. Similarly, an individual is treated as owning any interest that is owned by the individual's children.

Attribution of a parent's ownership interest to his or her child, or the attribution of a child's ownership interest to his or her parent, under IRC §318 occurs regardless of the child's age. A legally adopted child is treated as the individual's child for attribution purposes.[8]

EXAMPLE 4-11. Attribution from Parent to Child. Assume the same facts as in EXAMPLE 4-9. Joe and Lila have three children. Each child is also treated as owning 100 percent of Corporation T, because the stock owned by Joe is attributed to each of his children.

EXAMPLE 4-12. Attribution from Child to Parent. Tracey's daughter is a 25 percent owner of Corporation Q. Tracey is treated as owning 25 percent of Corporation Q because of the attribution of her daughter's interest to her.

Attribution between grandparents and grandchildren. A grandchild's ownership interest is attributed under IRC §318 to that individual's grandparent. However, a grandparent's ownership interest is not attributed under IRC §318 to that individual's grandchild.

EXAMPLE 4-13. Attribution Between Grandchild and Grandparent. Mary owns 50 percent of the stock of Corporation Q. Her grandchild, Paul, owns the other 50 percent. Mary is treated as a 100 percent owner of Corporation Q because she is attributed her grandchild's ownership. Paul, however, is not treated as owning Mary's interest because an individual is treated as owning his parent's interest, but not his grandparent's interest.[9]

No double attribution. If an individual is attributed ownership from a family member, the ownership interest attributed to that individual is not attributed again from that individual to another family member.[10] This is known as the prohibition on double attribution.

EXAMPLE 4-14. No Double Attribution. Assume the same facts as in **EXAMPLE 4-13**. Paul's mother, Susan, is Mary's daughter. Mary's stock would be attributed to Susan, because of attribution from parent to child, as described above. Paul's stock would also be attributed to Susan, because of attribution from child to parent. Although stock was attributed from Mary to Susan (parent to child), it is not then attributed to Paul (i.e., child to grandchild), because there is no double attribution.

[6] Rev. Rul. 58-66, 1958-1 CB 60 (1/1/58).

[7] Rev. Rul. 2013-17, IRB 2013-38 (9/16/13); Notice 2014-19, IRB 2014-17 (4/21/14).

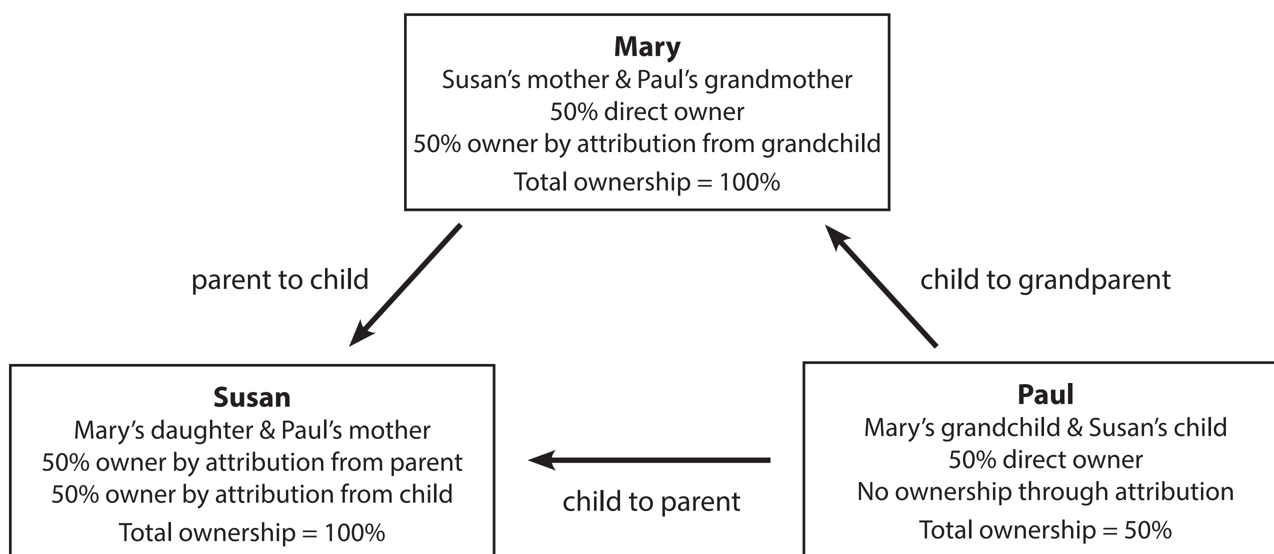
[8] IRC §318(a)(1)(B).

[9] Treas. Reg. §1.318-2(b).

[10] IRC §318(a)(5)(B).

Thus, for HCE determination purposes, Susan is treated as a 100 percent owner of Corporation Q because she is attributed her mother's ownership and her son's ownership. Paul, however, is treated as owning only his 50 percent, because of the prohibition on double attribution.

Below is an illustration of these concepts.



EXAMPLE 4-15. No Double Attribution. Frank owns 100 percent of Corporation B. Frank has a daughter, Nancy, who is married to Walden. Frank's 100 percent ownership interest is attributed to Nancy. There is no attribution from Frank directly to his son-in-law, Walden.

Although Nancy is treated as owning Frank's 100 percent due to family attribution, that interest is not treated as owned by Nancy for purposes of attributing that interest to her husband, Walden. In other words, Frank's ownership is not attributed once to Nancy as his daughter, and then attributed a second time from Nancy to Walden because of the spousal attribution.

The purpose of the no-double-attribution rule is to prevent multiple tiers of family attribution, so that an individual's indirect ownership through attribution is not then treated as direct ownership to apply another round of family attribution. Nonetheless, be sure not to confuse the no-double-attribution rule with the ability of an individual to attribute his or her ownership interest to one or more family members.

EXAMPLE 4-16. More than One Child. Hector owns 40 percent of Corporation W. Hector has three children. Each child is treated as owning 40 percent of Corporation W through the attribution rule. The attribution of Hector's stock directly from him to more than one child is not double attribution. However, because of the no-double-attribution rule, if any child is married, the attributed ownership of Hector's stock is not attributed a second time to that child's spouse.

The no-double-attribution prohibition only prevents double attribution through the family attribution rule. An ownership interest that is attributed to an individual through family attribution is taken into account in applying the other attribution rules described below.[11]

Attribution between siblings. IRC §318 does not provide for any attribution of ownership among siblings.

EXAMPLE 4-17. Attribution Among Siblings. Samantha and Paul are brother and sister. Samantha

[11] IRC §318(a)(5)(A).

owns 50 percent of Company X. Paul is not attributed Samantha's ownership interest in X.

The no-double-attribution rule prevents "rebound" attribution from one sibling to another through a parent. For example, suppose Carla is Samantha and Paul's mother. Samantha's interest in X is attributed to Carla, because Carla is Samantha's mother. However, the stock attributed to Carla is not again attributed to her son Paul because of the no-double-attribution rule.

Summary of family attribution

1. Attribution between spouses
2. Attribution from parent to child
3. Attribution from child to parent
4. Attribution from grandchild to grandparent

No attribution from grandparent to grandchild
No attribution between siblings

Attribution from an Organization

Attribution from a corporation to its shareholders. If a corporation has an ownership interest in another organization, that interest is attributed proportionately to any person who owns at least 5 percent of the value of the stock of the corporation.[12] This attribution does not apply if the 5 percent ownership is based on voting power.

To determine if the person owns at least 5 percent of the corporation, and is thus subject to attribution of interests owned by that corporation, the value of all stock is taken into account. Note that this test differs from the determination of whether an individual is an HCE, where an ownership percentage test is satisfied if it is met on the basis of the percentage of value of all shares or on the basis of the percentage of voting rights. Additionally, this test for attribution is met when the value equals 5 percent. (Do not confuse this determination with the 5 percent owner definition, which requires the value to exceed 5 percent.)

EXAMPLE 4-18. Corporation Owns Stock in Another Corporation. Jenny owns 60 percent of the stock of Corporation X. Brian owns 3 percent of Corporation X. Corporation X has a 25 percent stock interest in Corporation W, with the remaining 75 percent owned by other unrelated persons.

Jenny owns at least 5 percent of Corporation X, so she is attributed a proportionate share of the Corporation W stock owned by Corporation X. Because Jenny owns 60 percent of Corporation X, she is attributed 60 percent of the Corporation W stock owned by Corporation X. As a result, Jenny's attributed ownership is 15 percent of Corporation W's stock (i.e., 60 percent of Corporation X's 25 percent interest in Corporation W).

Brian is not attributed any Corporation W stock because he does not own at least 5 percent of Corporation X.

Owner	Direct Ownership	Attributed Ownership
Jenny	60% of Corp. X	15% of Corp. W (i.e., 60% of what X owns)
Brian	3% of Corp. X	0%
X	25% of Corp. W	—

EXAMPLE 4-19. CORPORATION OWNS INTEREST IN A PARTNERSHIP. Assume the same

[12] IRC §318(a)(2)(C), as modified by IRC §414(q)(3).

facts as in **EXAMPLE 4-18**, except W is a partnership and Corporation X has a 25 percent partnership interest in Partnership W. The same analysis applies. Jenny is treated as having a 15 percent partnership interest in Partnership W.

If You're Curious . . .

Attribution to partners from partnership. If a partnership has an ownership interest in another organization, that interest is attributed to the partners, in proportion to each partner's interest in the partnership. Note that this attribution rule applies to all the partners, while the one for corporations applies only to a 5 percent or more shareholder of the corporation.[13]

EXAMPLE 4-20. Attribution to Partners. Lester and Hester are partners in Partnership Q. Lester's partnership interest is 60 percent and Hester's is 40 percent. Partnership Q owns a 50 percent stock interest in Corporation M. The Corporation M stock is attributed to Lester and Hester in proportion to their partnership interests. Lester is treated as owning 30 percent of the Corporation M stock (60% of 50%) and Hester is treated as owning 20 percent of the Corporation M stock (40% of 50%).

Attribution to shareholders from S corporations and to members from LLCs. The partnership rule above applies to S corporations and to most LLCs. Even though an S corporation is a corporation, it is treated as a partnership for purposes of the IRC §318 attribution rules. Also, most LLCs are treated as partnerships for federal tax purposes.

No attribution from ESOPs and other qualified plans to plan participants. If an interest is owned by a qualified plan, including an ESOP, the interest is not attributed to the participants of the plan.[14]

EXAMPLE 4-21. ESOP. Sharon is a participant in an ESOP maintained by Corporation Y. Sharon's account balance in the ESOP is currently allocated shares in Corporation Y that equal 3 percent of Corporation Y's common stock. Sharon is not attributed that ownership under IRC §318.

Attribution related to option to acquire an ownership interest. If a person has an option to acquire stock, he or she is treated as owning that stock under these attribution rules.[15] An option for this purpose includes an option to acquire an option to acquire stock, and each one of a series of such options is considered an option to acquire the underlying stock.

COMPENSATION TEST

IRC §414(q)(1)(B) contains the **compensation test**. An employee is an HCE under the compensation test if the employee's compensation for the lookback year is more than a prescribed dollar amount (subject to the top-paid group election, if applicable). The lookback year is the 12-month period preceding the current plan year.

The original dollar amount was $80,000, but that amount is subject to cost-of-living indexing by the IRS. Because compensation is determined for the lookback year, the employee's compensation for the current plan year has no bearing on the employee's HCE status for that year.

Compensation limits for recent past years are:

[13] IRC §318(a)(2)(A).

[14] See the parenthetical language in IRC §318(a)(2)(B)(I).

[15] IRC §318(a)(4).

Calendar Years Beginning in	Compensation Limit
2009	$110,000
2010	$110,000
2011	$110,000
2012	$115,000
2013	$115,000
2014	$115,000
2015	$120,000
2016	$120,000
2017	$120,000
2018	$120,000

EXAMPLE 4-22. General Application of Compensation Test. Corporation Z's 401(k) plan has a calendar plan year. For the current plan year, Corporation Z has 80 employees. The compensation test is applied by looking at these 80 employees' compensation for the prior calendar year (i.e., the lookback year). Only seven of those employees had compensation in excess of the dollar amount in effect for that calendar year. Only these seven employees satisfy the compensation test for the current plan year.

EXAMPLE 4-23. No 5 Percent Owners. Suppose in **EXAMPLE 4-22** that none of the 80 employees satisfy the 5 percent owner test. The seven employees determined to be HCEs by satisfying the compensation test are the only HCEs for the current plan year.

When the dollar amount used for the compensation test is increased for a calendar year, it applies to compensation for lookback years that begin in that calendar year.[16] For example, the compensation amount is $120,000 effective January 1, 2017. The increased amount applies to lookback years that begin in 2017. That means that the increase generally has no effect until plan years beginning in 2018. The IRS confirmed this interpretation in a general information letter to Watson Wyatt.[17]

EXAMPLE 4-24. Calendar Year Plan. A plan has a plan year that ends December 31. For the plan year starting January 1, 2018, the plan must look at compensation for 2017 to see who satisfies the compensation test. An employee's 2017 compensation must exceed $120,000 to satisfy the compensation test (the dollar amount in effect for 2017).

Because the dollar amount in effect for 2017 and 2018 remained unchanged, the $120,000 amount was also used for the plan year starting in 2018 (lookback year 2017).

EXAMPLE 4-25. Noncalendar Year Plan. A plan has a plan year that ends June 30. The $120,000 amount is used to apply the compensation test for the plan year that starts on July 1, 2017, because the lookback year for that plan year (i.e., July 1, 2016, through June 30, 2017) begins in 2016.

Calendar Year Data Election

A **calendar year** data election will affect the calculation of the lookback year. If the election is made, the lookback year

[16] Treas. Reg. §1.414(q)-1T, Q&A-3(c)(2).

[17] See report in *BNA Pension and Benefits Reporter*, 12-13-99 issue, page 2884, and the reprinted letter in CCH Pension Plan Guide, 17,202D).

is the calendar year that begins in the 12-month period preceding the current plan year. For example, if the employer makes the calendar year data election for a plan year beginning October 1, 2017, the lookback year is calendar year 2017, because that is the calendar year that began in the 12 months preceding the current plan year (October 1, 2016, through September 30, 2017).

The calendar year data election applies only to determine the lookback year for the compensation test and does not apply to determine the HCEs under the 5 percent owner test, consistent with the present statutory language under IRC §414(q). In addition, the calendar year data election may be made only for a noncalendar year plan. Because a calendar year plan may not make the election, the lookback year for the calendar year plan's compensation test will always be the prior calendar year.

The calendar year data election must be reflected in the document only if a plan otherwise contains an HCE definition. If a plan does not include a definition of HCE, the calendar year data election may be made operationally. The consistency rules discussed below with regard to the top-paid group election are also applicable to the calendar year data election.

Top-Paid Group Election

The employer may elect to (but is not required to) limit the number of employees who can be treated as satisfying the compensation test. Under the **top-paid group election**, an employee would satisfy the compensation test only if:

- the employee was in the top 20 percent of employees for the lookback year, ranked by compensation, and
- the employee's compensation for such prior year was in excess of the required dollar amount.[18]

This election is known as the top-paid group election or the top-paid group limitation. To determine the maximum number in the top-paid group, the 20 percent limitation is applied to the total number of employees, disregarding certain excluded employees. For example, if there are 80 employees (other than excluded employees), then the top-paid group election will limit the number of employees who can be treated as satisfying the compensation test to 16 (that is, 20% × 80).

When the top-paid group election is made, an employee who is not in the top-paid group for the lookback year is treated as an NHCE, even if compensation exceeded the applicable dollar amount for that lookback year, unless the employee satisfies the 5 percent owner test.

Manner of Making the Election

The employer, in its discretion, may choose whether to use the top-paid group election. The employer's election must be stated in the plan document only if the plan document contains a definition of HCE.[19]

If the document does not include a definition of HCE, then the election may be made without having to add a definition to the plan and without having to provide for the election in the plan. When the top-paid group election is made, it applies to the plan year in which it is effective and to all subsequent plan years until it is revoked. If a plan document specifies that the top-paid group election applies, then an amendment must be adopted to revoke the election. The employer does not have to notify the IRS of the election nor obtain the IRS' consent to make or to revoke the election.

The IRS takes the position that changes in the testing options, such as the top-paid group election, must be adopted before the end of the plan year in which they are effective.[20]

An employer will make the top-paid group election when having a more limited number of HCEs under the compensation test will produce (or is expected to produce) more favorable testing results. For example, suppose an employee whose compensation was $150,000 in the lookback year was not in the top 20 percent of employees, ranked by compen-

[18] IRC §414(q)(3).

[19] Notice 97-45, Section VII.

[20] Rev. Proc. 2005-66, IRB 2005-37.

sation, for the lookback year. Also suppose that the employee defers the maximum allowed under IRC §401(a)(30) (e.g., $18,500 in 2017). By making the top-paid group election, this employee would be in the NHCE group (assuming he or she is not a 5 percent owner). With the high deferral rate generated by this employee's level of elective contributions, having the employee in the NHCE group should help the nondiscrimination testing results under IRC §401(k)(3) (the ADP test). ADP testing is discussed in detail in *The ASPPA Defined Contribution Plan Series Volume 2: 401(k) Plans and Intermediate Administrative Topics*, which is available at the ASPPA bookstore (ecommerce.asppa-net.org).

Consistency Rule

The top-paid group election applies for all testing purposes for any plan year in which the election is in effect. For example, an employer is not permitted to elect to use the top-paid group election to determine HCEs for purposes of applying the ADP nondiscrimination test for its 401(k) arrangement, but then opt out of the election to determine HCEs for purposes of applying the coverage test for the same plan year.

If an employer maintains two or more plans with different plan years, the election to use the top-paid group election must apply to all plan years for each plan that begins in the same calendar year.

Application of the Election

When determining which employees are in the top-paid group, employees are ranked in descending order of compensation, regardless of whether they also satisfy the 5 percent owner test. Therefore, it is possible for an employee who is a 5 percent owner to be in the top-paid group, as well. That does not mean that the person is ignored so that a lesser-compensated employee, who is not a 5 percent owner, may be added to the top-paid group.

EXAMPLE 4-26. Effect of Top-Paid Election. A top-paid group election is in effect for the 2018 calendar plan year. For the lookback year (calendar year 2017), the following individuals had compensation over the required compensation amount in effect for such lookback year.

Employee	Compensation
Jared	$225,000
Pamela	$190,000
Antonia	$171,000
Phillip	$145,500
Mimi	$135,000

If the top-paid group election is not in effect, all five of the listed employees would be treated as HCEs for the plan year, because they have all earned more than the compensation threshold in the lookback year. Jared and Antonia also satisfy the 5 percent owner test. The company had 15 employees in the lookback year, so the top-paid group is limited to three employees (i.e., 20% x 15 = 3). Because Jared, Pamela and Antonia are the three top-paid employees in the lookback year, they are the ones who satisfy the compensation test for the plan year for which the top-paid group election is in effect.

Phillip and Mimi are not part of the top-paid group and are not 5 percent owners. Therefore, they are treated as NHCEs for the plan year. We do not drop out Jared and Antonia from the top-paid group determination, merely because they also satisfy the 5 percent owner test, and include Phillip and Mimi in their place.

As noted, the top-paid group election applies only to the compensation test and does not affect whether an employee is an HCE under the 5 percent owner test. For example, suppose an employee owns more than 5 percent of the company during a plan year. For the lookback year (i.e., the 12 months preceding the first day of the plan year), the employee ranked in the 23rd percentile by compensation. The employee still is an HCE, because of the 5 percent owner test, even

though the employee is not part of the top-paid group for the lookback year.

Suppose instead that a company with ten employees has five employees who are equal owners of the company. All five of the owners are HCEs under the 5 percent owner test, even if the 20 percent top-paid group election is elected for the compensation test despite the fact that the five owners represent 50 percent of the workforce. In **EXAMPLE 4-26** above, if Phillip and Mimi were the two 5 percent owners instead of Jared and Antonia, then all five employees in that example would be HCEs. Jared, Pamela and Antonia would be HCEs under the compensation test, because they represent the top-paid group, and Phillip and Mimi would be HCEs under the 5 percent owner test.

In all of the above calculations, husbands and wives are treated as separate individuals. For example, suppose an employer has 15 employees, but those 15 employees include three married couples and nine other related individuals. Further assume that none of the 15 employees is an excluded employee. The relevant number of employees taken into account for the top 20 percent is 20 percent of 15, not 20 percent of 12. In other words, we treat each of the 15 employees as separate individuals, even though there are three sets of married couples included in the group. In addition, if a husband and wife were both in the top 20 percent, we include both of them as separate HCEs. In **EXAMPLE 4-26** above, if Jared and Pamela are married to each other, we do not treat them as one HCE and then bring Phillip into the top 20 percent.

As discussed above, there is attribution of stock ownership between spouses. Therefore, the ownership of stock by a husband would be attributed to the wife for purposes of the 5 percent owner test. In **EXAMPLE 4-26**, if Antonia happens also to own more than 5 percent of the employer, and she is married to Phillip, then Phillip would be attributed her ownership and he would be an HCE by reason of the 5 percent owner test, even though the 20 percent top-paid group election takes him out of the compensation test.

EXAMPLE 4-27. Effect of Electing the Top-Paid Group Election. Law Firm C has 170 employees for the plan year that begins January 1, 2018 (the 2018 plan year): 60 are shareholders and 110 are nonshareholders. All 60 shareholders had compensation in 2017 (i.e., the lookback year) above $120,000 (i.e., the dollar requirement in effect for that year). No one has an ownership interest greater than 5 percent and no employees are related to any owners. Of the nonshareholders, 19 of 110 had compensation above $120,000 in 2017.

Top-paid group election not made. Assume Law Firm C does not elect to apply the top-paid group election for the 2018 plan year. For the 2018 plan year, 79 employees satisfy the compensation test, because all 60 shareholders and 19 nonshareholders had compensation above $120,000 in 2017. Because none of the shareholders is a 5 percent owner, the 5 percent owner test is not satisfied by any of them. Law Firm C has a total of 79 HCEs for the 2018 plan year.

Top-paid group election made. Assume Law Firm C elects to apply the top-paid group election for the 2018 plan year. Whether the 79 employees described above are HCEs depends on whether they were included in the top-paid group for the lookback year (i.e., 2017). Therefore, we first need to determine the number of employees the Law Firm had in 2017 so we can determine the number of employees that would constitute the top 20 percent for that year.

Assume that Law Firm C had 160 employees in 2017 and that none of the 160 employees fell into the excluded employee categories under the top-paid group election. The top-paid group election is 20 percent × 160, or 32. Law Firm C would rank the 32 most highly paid employees (both shareholders and nonshareholders) for 2017. The employer then would compare that list of 32 employees to the 79 employees in the 2018 plan year who were paid more than $120,000 in 2017. Any of those 79 employees who also were one of the 32 most highly paid employees for 2017 would be treated as HCEs and the rest would be treated as NHCEs for the 2018 plan year.

Suppose that 32 of the 60 shareholders who are employees in the 2018 plan year also were the 32 most highly paid employees in 2017. The other 28 shareholders and the 19 nonshareholders now would be treated as NHCEs for the 2018 plan year, even though these employees had compensation

above $120,000 in 2017.

Suppose that only 29 of the 60 shareholders who are employees in the 2018 plan year were also part of the 32 most highly paid employees for 2017, because three of the top-paid group members for 2017 had left Law Firm C by December 31, 2017. In that case, only the 29 employees for the 2018 plan year who were also included in the top-paid group for 2017 are HCEs for the 2018 plan year. The other 50 employees (31 shareholders and 19 nonshareholders) are NHCEs for the 2018 plan year because they were not part of the top-paid group for 2017, even though they had compensation above $120,000 in 2017. As this **EXAMPLE 4-27** illustrates, we do not replace the three members of the lookback year's top-paid group who terminated by the end of that year with other lesser paid employees in order to treat 32 employees for the 2018 plan year as HCEs.

EXAMPLE 4-28. New Employee. Stacy is hired by Corporation Z on March 1, 2017. Stacy is paid $125,000 of compensation during 2017. Corporation Z has a 401(k) plan with a plan year ending December 31. Stacy is not an owner of Z. Stacy is an NHCE for 2017 because she does not satisfy either HCE test. Because Stacy was hired during the current plan year, she cannot satisfy the compensation test because her compensation for the lookback year (2016) was $0.

Suppose instead that Stacy was brought into Corporation Z as an owner. If Stacy owns more than 5 percent of Z at any time during 2017, she is an HCE for the 2017 plan year under the 5 percent owner test. However, if her ownership interest at all times during 2017 is 5 percent or less, she will still be an NHCE for that year. Also, if Stacy is related to any of the owners, and that family relationship results in attribution of ownership to Stacy, then the attributed ownership is taken into account to determine if Stacy satisfies the 5 percent owner test for the 2017 plan year.

Suppose that Stacy is not an owner, but was hired on November 1, 2017, rather than during the 2018 plan year. For the two months in 2017 that she worked for Corporation Z, she was paid $20,000. On an annualized basis, Stacy would have earned over $120,000 for 2017. However, only her actual compensation for the lookback year (2017) is taken into account, even if she works only a portion of the year. Because her actual compensation for the lookback year was only $20,000, she does not satisfy the compensation test for the 2018 plan year.

Excluded Employees

The following employees generally are excluded under the top-paid group election by reason of IRC §414(q)(5). This means that they are not included in the total number of employees for purposes of determining how many employees represent the top 20 percent.

Age and service exclusions. When calculating the number of employees who are in the top 20 percent group, the following individuals are not counted:

- employees who have not completed at least six months of service by the end of the year;
- employees who normally work less than 17½ hours per week;
- employees who normally work less than six months per year; and
- employees younger than age 21.

The employees who normally work less than 17½ hours per week or less than six months per year can be identified on a group basis (e.g., by job category).

The employer may modify these exclusions to use shorter service requirements or a lower age requirement, if the modification is applied uniformly to all employees.[21]

[21] Treas. Reg. §1.414(q)-1T, A-9(b)(2).

Notwithstanding the exclusion of these individuals from the *count* to determine the top 20 percent, they are still included in the determination of which employees are HCEs. Therefore, if they have earned enough to be in the top paid group, they may still be treated as an HCE.

EXAMPLE 4-29. Member of Top-Paid Group Excluded from the Count. Suppose an employer has 80 total employees in the prior year, but 20 are excluded from the count under these age and service categories. Sherry is one of the excluded employees because she has less than six months of service as of the end of the year. To determine the number in the top-paid group, the employer multiplies 60 (80 employees less 20 excludable employees) by 20 percent, to arrive at 12.

Although only 60 employees were considered when determining the number of employees in the top-paid group, all 80 employees are considered in the determination of which 12 employees have the highest compensation. If Sherry is one of the 12 most highly paid for the year, she is part of the top-paid group (assuming her compensation exceeds the applicable dollar amount under the compensation test).

The above exclusions are solely for the limited purpose of determining the number of employees in the top paid group. The exclusions are not related to a plan's eligibility conditions. For example, a plan might provide that all employees with three months of service are eligible for the plan, but could still exclude all employees with less than six months of service to determine the number in the top-paid group.

Union employees. If 90 percent or more of the employees are covered by collective bargaining agreements (CBAs), the employees covered by a CBA are excluded only if the plan being tested does not benefit any employees covered by that CBA.[22] Union employees excluded under this rule are disregarded in determining the number in the top-paid group and in determining who is included in that top-paid group. The employer may elect not to apply this exclusion.[23]

EXAMPLE 4-30. Union Employees. For the lookback year, an employer has 500 employees, 470 of whom are union employees and 30 of whom are nonunion employees. The nonunion plan is being tested for coverage. Because 90 percent or more (i.e., 470/500 exceeds 90 percent) of the employer's employees are union employees, those employees may be excluded in determining the number in the top-paid group. Thus, assuming none of the 30 nonunion employees are excluded under the age and service exclusions, the number in the top-paid group is six (i.e., 20% x the 30 nonunion employees). The six in the top-paid group are those six nonunion employees whose compensation in the lookback year exceeded the applicable dollar amount. Whether any union employees had greater compensation is irrelevant because they are excluded in determining who is in the top-paid group for the lookback year.[24]

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Effect of Related Groups

Any category of HCE that is based wholly or partly on an employee's compensation is determined by combining the compensation the employee receives from all related group members. For example, an employee would satisfy the compensation test if the employee's combined compensation in the lookback year from all the related group members exceeds the required dollar amount under the compensation test. If a percentage of the number of employees is relevant to the determination of a category of HCEs (e.g., top-paid group election), that percentage is applied on a related group basis.

[22] Treas. Reg. §1.414(q)-1T, A-9(b)(1)(iii).
[23] Treas. Reg. §1.414(q)-1T, A-9(b)(1)(ii).
[24] Treas. Reg. §1.414(q)-1T, A-9(b)(1)(iii)(B).

EXAMPLE 4-31. Compensation Paid by More Than One Related Group Member. Corporation X is the parent company of Corporation Y, within the meaning of the controlled group definition under IRC §414(b). Corporation X maintains a 401(k) plan. The plan year of Corporation X's plan ends December 31. The employees of Corporation Y are not eligible for this plan.

Fariq is compensated from both companies. When the Corporation X plan determines who is highly compensated for a plan year, Fariq's combined lookback year compensation from both Corporations X and Y is taken into account, even though Corporation Y does not participate in Corporation X's plan. If a top-paid group election is made, Fariq satisfies the compensation test only if he is in the top 20 percent of employees, ranked by compensation, of the combined workforces of Corporations X and Y, taking into account his compensation from both companies.

Under the top-paid group election, the 20 percent limit is determined on the basis of the combined workforces of the related group members. Therefore, the top-paid group election may be used only if all members of the related group elect it. This is true even if the members of the related group are qualified separate lines of business (QSLOBs) under IRC §414(r). Also, the employees of all the related group members are ranked in the order of compensation to establish the members of the top-paid group. In other words, each related group member does not compute its own top 20 percent from its respective workforce.

Compensation

To apply the compensation test described above, a participant's compensation is his or her IRC §415 compensation, as defined by the plan.[25] The definition of IRC §415 compensation is found in Treas. Reg. §1.415(c)-2.

IRC §415 compensation includes elective contributions. In other words, the elective contributions are added back to determine the employee's compensation. Because of this rule, an employee cannot defer himself or herself out of HCE status. Elective contributions for this purpose means elective deferrals described in IRC §402(g)(3) [i.e., pre-tax elective contributions and designated Roth contributions under a 401(k) arrangement, 403(b) plan, SIMPLE IRA or SARSEP],[26] as well as contributions made at the employee's election to a cafeteria plan under IRC §125 or to an eligible 457 plan [i.e., a 457(b) plan] and elective deferrals used to purchase qualified transportation fringe benefits, pursuant to IRC §132(f)(4).

EXAMPLE 4-32. Compensation for HCE Testing. Daniel's annual compensation is $130,000. For the lookback year, he made elective contributions into a 401(k) arrangement and made elective deferrals under a cafeteria plan in the amount of $15,000, resulting in net compensation for the lookback year of $115,000. To determine whether Daniel satisfies any of the HCE tests for the current plan year, his compensation is $130,000, not $115,000.

Amounts deferred under a *nonqualified* deferred compensation arrangement are not includible in the definition of IRC §415 compensation and, therefore, are not part of compensation for HCE purposes.[27] (Distributions from a nonqualified deferred compensation arrangement may in some cases be treated as IRC §415 compensation, but not contributions under the arrangement.) Usually an employee who is eligible for a nonqualified deferred compensation arrangement will have compensation well in excess of the compensation requirement needed to be an HCE, even after the nonqualified plan deferral is subtracted. However, the deferral under the nonqualified arrangement might affect

[25] IRC §414(q)(4).
[26] IRC §402(g)(3).
[27] Treas. Reg. §1.415-2(d)(3)(I).

whether the employee is in the top-paid group where the employer has made the top-paid group election.

TESTING PERIOD FOR DETERMINING WHO IS AN HCE

The testing period for determining HCEs is the prior year, for purposes of the compensation test, and the current and prior year for purposes of the 5 percent owner test. IRC §414(q) refers to the term "year" but does not define what a year is. Treasury Regulations provide that the year means both the determination year and the lookback year for purposes of the 5 percent owner test and only the lookback year for purposes of the compensation test.[28] The determination year is the current plan year and the lookback year is the 12 months preceding the determination year (subject to the calendar year data election, if applicable).

No special exception is provided for the first plan year of a new plan. Even though there is no prior plan year, the lookback year is still the 12-month period preceding the first plan year.

EXAMPLE 4-33. First Plan Year. A corporation establishes a new 401(k) plan effective January 1, 2018. The plan year ends December 31. For the first plan year (i.e., the 2018 plan year), the determination year is the first plan year. The lookback year is calendar year 2017, which is the 12 months preceding the first plan year, even though the plan was not in existence during 2017. The HCEs for the 2018 plan year are determined as follows.

The HCEs under the 5 percent owner test are the employees in the 2018 plan year who at any time during the lookback year (2017) or the determination year (2018) owned more than 5 percent of the corporation.

The HCEs under the compensation test are the employees in the 2018 plan year whose compensation for 2017 exceeded $120,000, subject to the top-paid group election, if elected.

Suppose the employer was not in existence in the prior year. Unless special rules are created in future guidance, it is assumed that if the employer did not exist prior to the first day of the plan year, then no employees are HCEs under the compensation test, because compensation for all employees would be $0 in the lookback year. The only HCEs would be the employees, if any, who own more than 5 percent of the employer for the determination year (the first plan year).

EXAMPLE 4-34. New Business Formed. Bob, Ted and Alice quit their jobs and decide to start their own business. They form a partnership in 2018, each an equal one-third partner. They also want to establish a 401(k) plan right away. They all were participating in 401(k) plans with their prior employers and want to continue doing so in their new business. A 401(k) plan is established effective January 1, 2018. For the 2018 plan year, the only HCEs are Bob, Ted and Alice, each of whom satisfies the 5 percent owner test during 2018 (the determination year). None of their employees is an HCE because no one other than Bob, Ted and Alice has an ownership interest and every employee's compensation for the lookback year (i.e., 2017) is $0 because the company was not in existence in that year.

Suppose in **EXAMPLE 4-34** that a plan was made effective May 1, 2018, rather than January 1, 2018, with the first plan year ending December 31, 2018. Then the determination year for the first plan year runs from May 1, 2018, to December 31, 2018. The lookback year is now May 1, 2017, through April 30, 2018. If the partnership was in existence for part of that lookback year, then it is possible that some of the other employees may have enough compensation in the lookback year to make them HCEs for the first plan year (subject to the top-paid group election, if applicable).

[28] Treas. Reg. §1.414(q)-1T, A-3(a).

EXAMPLE 4-35. Second Plan Year Determination Under New Business's Plan. Suppose in the prior **EXAMPLE 4-34** that the partnership is in existence in 2018 only from May 1 through December 31, 2018. When the HCE test is performed for the second plan year (January 1, 2019 to December 31, 2019), the lookback year is the 12 months preceding the 2019 plan year (i.e., January 1, 2018 through December 31, 2018). Therefore, there is no need to prorate the compensation requirement in effect for the lookback year to determine whether an employee satisfies the compensation test for the 2019 plan year, even though compensation would have been paid only for eight months during the lookback year.

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A different issue arises where the business is new but a prior business existed that may have to be treated as a predecessor employer. If, in EXAMPLE 4-34, the partnership is required to take into account service with a predecessor employer, then compensation paid by that predecessor employer during the lookback year would be counted in determining the HCEs for the first plan year of the partnership's plan.

Only the determination year can be a short year because it is defined to be the plan year. The lookback year can never be a short year because it is defined as the 12-month period preceding the determination year. A short plan year will occur when the plan year is amended. For example, if a plan has a plan year ending September 30, and the employer amends the plan year to the calendar year, a short plan year will be created from October 1 through December 31. The first plan year of a new plan also might be a short plan year. For example, if a new plan is established with an April 1 effective date, but the plan year ends December 31, the first plan year will be a nine-month period running from April 1 to December 31.

A short plan year does not affect the compensation test because that test is based on compensation for the lookback year, and the lookback year is always a 12-month period, even if the prior plan year was a short year. The current plan year information is only relevant for the 5 percent owner test, which does not have a compensation requirement. Therefore, proration of the HCE compensation test amount is never required.

EXAMPLE 4-36. Short Plan Year. An employer maintains a 401(k) plan with a June 30 plan year end. Effective January 1, 2018, the plan year is amended to a calendar year, creating a short plan year from July 1, 2017 through December 31, 2017.

For the short plan year, that starts on July 1, 2017, and ends on December 31, 2017, the HCEs are the following employees:

1. ***5 percent owner test***. The HCEs under the 5 percent owner test are the employees who own more than 5 percent of the company at any time during the lookback year (i.e., July 1, 2016 to June 30, 2017) or the determination year (i.e., the current short plan year of July 1, 2017, to December 31, 2017).
2. ***Compensation test***. The HCEs under the compensation test are the employees whose compensation for the lookback year (i.e., July 1, 2016 to June 30, 2017) exceeds $120,000, subject to the top-paid group election, if elected. There is no proration of the $120,000 compensation requirement because compensation is measured for a 12-month lookback year.

The plan year ending December 31, 2018, is the first 12-month plan year following the amendment of the plan year. Although the prior plan year was a short period (July 1, 2017 to December 31, 2017), the lookback year is the 12 months preceding the current plan year (i.e., January 1, 2017 to December 31, 2017). The HCEs are the following employees:

1. 5 percent owner test. The HCEs under the 5 percent owner test are the employees who own more than 5 percent of the company at any time during the lookback year (i.e., January 1, 2017 to December 31, 2017) or the determination year (i.e., January 1, 2018 to December 31, 2018).
2. Compensation test. The HCEs under the compensation test are the employees whose compensation for the lookback year (i.e., January 1, 2017 to December 31, 2017) exceeds $120,000, subject to the top-paid group election, if elected. No proration is necessary because the lookback year is a 12-month measuring period.

Suppose a new plan is established in April 2018, but was made effective retroactive to January 1, 2018. The lookback year for the first plan year would be January 1, 2017 to December 31, 2017.

ROUNDING AND TIE-BREAKING

The HCE tests may involve rounding or tie-breaking calculations. This may occur, for example, if the top-paid group election is made for the compensation test. A rounding situation would occur when the 20 percent calculation results in a fractional number, such as 11.4. A tie-breaking situation would occur when there are nine employees that must be included in the top-paid group, but the tenth-ranked employee has the same compensation as the ninth-ranked employee. Pursuant to Treas. Reg. §1.414(q)-1T, A-3(b), any reasonable method of rounding or tie-breaking is permitted. For example, it would be reasonable to round numbers ending in ".5" or less to the next lower integer, and numbers ending above ".5" to the next higher integer. The method used must be nondiscriminatory, and uniformly and consistently applied.

If You're Curious . . .

LEASED EMPLOYEES

A leased employee is one who is a common-law employee of one company (called the leasing organization) but who, by a formal or informal agreement, performs services under the direction and control of another company (called the recipient) for a period of at least 12 months.[29] Leased employees are treated as the recipient employer's employees for purposes of the HCE determination made for any plan maintained by the recipient employer.[30]

The leased employee's compensation paid by the leasing organization is treated as compensation from the recipient employer to determine whether the leased employee is an HCE with respect to the recipient employer. If the leased employee is leased to more than one recipient employer, then each recipient takes into account only the compensation attributable to services provided to that recipient [unless the recipients are related employers under the affiliated service group or controlled group definitions in IRC §414(b), (c) or (m)]. Any determination based on a percentage of the recipient's number of employees is determined by including the leased employees in the recipient's workforce.

EXAMPLE 4-37. Leased Employees. Nick is a leased employee for recipient Employer Q. Q maintains a qualified plan with a plan year ending December 31. For any plan year, Nick is an HCE if his compensation from the leasing organization for the lookback year is more than the applicable dollar amount under the compensation test. If Nick works for more than one recipient employer, only his compensation for the lookback year that is attributable to his services for Q is taken into account. If Q makes the top-paid group election, it must include Nick in its workforce to determine the number of employees to be included in the top 20 percent, unless Nick falls into one of the excluded employee categories described above.

[29] IRC §414(n).
[30] IRC §414(n)(3).

Remember that the leasing organization is the common law employer of the leased employee. If the leasing organization maintains a plan, it also must count the employee in its workforce and must take into account all compensation it pays the employee, regardless of whether the employee is leased to one or more organizations. In the prior EXAMPLE 4-37, Nick would also be part of the leasing organization's workforce to determine who the HCEs are under any plan maintained by the leasing organization.

NONRESIDENT ALIENS

Employees who are nonresident aliens and who receive no earned income [as defined in IRC §911(d)(2)] from U.S. sources are not treated as employees for purposes of the HCE determination.[31]

If You're Curious…

FORMER EMPLOYEES

The HCE tests described above apply to active employees. For certain qualification rules, it is necessary to determine who are highly compensated former employees. For example, if new benefits are accrued in a defined benefit plan for former employees (e.g., an ad hoc amendment to provide a cost-of-living adjustment), the coverage and nondiscrimination requirements must be satisfied with respect to those benefits. An employee who is an HCE in the year he or she separates from service is a **highly compensated former employee** in subsequent years.[32] Furthermore, if an employee is an HCE at any time after attaining age 55, the employee is a highly compensated former employee after his or her termination, regardless of whether the employee is an HCE in his or her separation year.[33] When determining whether an employee is an HCE in the year of separation or the year of attainment of age 55, presumably the HCE definition in effect for that year applies. Note that the definition of HCE was different for plan years beginning before 1997.

EXAMPLE 4-38. Active Employee Becomes NHCE After Age 55. Lily, age 57, is an employee of a corporation that maintains a 401(k) plan. Lily is not an owner of the corporation nor is she attributed ownership from another person. For the plan year beginning January 1, 2018, Lily is an HCE because, for the lookback year (2017) her compensation exceeded $120,000. (Assume the top-paid group election, if it is in effect, does not cause Lily to be an NHCE.) During 2018, Lily's position changes, and she also receives a significantly smaller bonus, so that her compensation for 2018 is only $72,000. Lily continues to be an employee for the plan year beginning January 1, 2018 (i.e., the 2018 plan year). For the 2019 plan year, Lily is now an NHCE because her lookback year compensation (i.e., her 2018 compensation of $72,000) is not sufficient to satisfy the compensation test.

EXAMPLE 4-39. Former Employee is Rehired. Suppose Lily terminates in 2018. For 2019 and 2020 she is a former employee. During that period she is considered to be a highly compensated former employee because, for at least one plan year after she had attained age 55, she was an HCE. In 2021, Lily is rehired, and she is again eligible for the company's 401(k) plan. Now that Lily is once again an employee, her status as an HCE or NHCE is determined under the rules that apply to employees. Her status as a highly compensated former employee does not cause her to be an HCE

[31] IRC §414(q)(8).
[32] IRC §414(q)(6)(A).
[33] IRC §414(q)(6)(B).

for years in which she is employed again. For the 2021 plan year, Lily is an NHCE under the 401(k) plan because for the lookback year (2020) her compensation was $0 and Lily is not an owner.

Section 4.04: Review of Key Concepts

- Describe the 5 percent owner test.
- How do the ownership attribution rules apply when determining HCEs?
- Describe the compensation test.
- Describe the calendar year data election.
- Describe the top-paid group election.
- Calculate the number of employees who are in the top-paid group.
- What is the determination year?
- What is the lookback year?
- Identify employees who are HCEs.

Section 4.05: For Practice – True or False

1. The identification of HCEs is necessary for determining whether the minimum coverage requirements of IRC §410(b) have been satisfied.
2. The determination year for identifying HCEs is the 12-month period immediately preceding the plan year.
3. The identification of HCEs is necessary for determining whether the nondiscrimination requirements of IRC §401(a)(4) have been satisfied.
4. The brother of a 5 percent owner is an HCE.
5. Absent a top-paid group election, all employees who earn more than $80,000, as indexed, in the lookback year are considered HCEs.
6. Employees who have not attained age 25 may be excluded from the top-paid group determination.
7. A 5 percent owner for purposes of determining who is an HCE is an individual who owns 5 percent of the business.
8. Employees who have been employed for nine months may be excluded from the top-paid group determination.
9. For the 2018 calendar year, only employees earning more than $120,000 in 2017 will be considered HCEs.
10. Jim owns 100 percent of ABC Company. Jim's daughter, Anne, and her husband, Mark, are employees of ABC Company. Mark is considered an HCE because he is a 5 percent owner due to attribution.

Section 4.06: Sample Test Questions

1. All of the following statements regarding HCE determination are TRUE, EXCEPT:
   - A. An employee's compensation for the current plan year has no bearing on the employee's HCE status for that year.
   - B. The lookback year is generally the 12-month period preceding the determination year.
   - C. The 5 percent owner test applies to the determination year and the lookback year.
   - D. The compensation test applies to the lookback year only.
   - E. An employee must satisfy the 5 percent owner test and the compensation test to be considered an HCE.

2. Which of the following statements regarding HCE determination is/are TRUE?

   I. The IRC §1563 attribution rules apply when determining HCEs.
   II. An employee who owns 5 percent of the employer fails to satisfy the 5 percent owner test.
   III. An individual who owns 10 percent of a corporation has an ownership interest via attribution in other entities owned by that corporation.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

3. All of the following are HCEs, EXCEPT:

   A. A sole proprietor
   B. The grandson of a 50 percent owner
   C. The spouse of a 10 percent owner
   D. The grandfather of a 30 percent owner
   E. The daughter of a 75 percent owner

4. All of the following statements regarding the calendar year data election are TRUE, EXCEPT:

   A. It is applicable when determining the lookback year for the 5 percent owner test.
   B. It is applicable when determining the lookback year for the compensation test.
   C. It may be made only for a noncalendar year plan.
   D. It must be reflected in the document if a plan contains an HCE definition.
   E. It may be made operationally if a plan document does not include an HCE definition.

5. Based on the following information, determine which of the following employees is/are HCEs for 2018:

   - The company employs 100 people.
   - The company sponsors a calendar year profit sharing plan.
   - Employee A is married to Employee D.
   - The employer has not made the top-paid group election.

Employee	Ownership (2017 and 2018)	2017 Compensation	2018 Compensation
A	60%	$150,000	$180,000
B	30%	$97,000	$97,000
C	5%	$87,000	$116,000
D	0%	$85,000	$85,000
E	5%	$50,000	$55,000

   A. Employee A only
   B. Employees A and B only
   C. Employees A, B and D only
   D. Employees A, B, C and E only
   E. Employees A, B, C, D and E

6. Based on the following information, determine which of the following employees is/are HCEs for 2018:
   - Employee A is married to Employee B .
   - Employee C's ownership was sold to Employee A on the last day of the 2017 plan year.
   - Employee D is the brother of Employee A.
   - Employee E is the child of Employees A and B.

Employee	2017 Ownership	2018 Ownership	2017 Compensation	2018 Compensation
A	90%	100%	$75,000	$90,000
B	0%	0%	$30,000	$35,000
C	10%	0%	$60,000	$50,000
D	0%	0%	$40,000	$45,000
E	0%	0%	$15,000	$20,000

A. Employee A only
B. Employees A and C only
C. Employees A, B and E only
D. Employees A, B, C and E only
E. Employees A, B, C, D and E

7. All of the following statements regarding the top-paid group election are TRUE, EXCEPT:
   A. Employees who have not completed six months of service by the end of the lookback year may be excluded.
   B. The plan sponsor is not required to use the top-paid group election to limit the number of HCEs.
   C. Employees who are more than 5 percent owners may be excluded.
   D. Employees who have not attained age 21 by the end of the lookback year may be excluded.
   E. The top-paid group election must be applied consistently to all compliance tests using HCE determinations.

8. Based on the following information, determine the minimum number of employees that must be included in the top-paid group for determining HCEs:
   - No employee in the table below is counted more than once.

Total employees	500
More than 5% owners	5
Employees under age 21	15
Employees who have not completed six months of service	75
Seasonal employees who work two months per year	10
Part-time employees who work approximately 20 hours per week	20
Full-time non-owner employees over age 21	375

   A. 75
   B. 80
   C. 84
   D. 99
   E. 100

9. Which of the following statements regarding stock attribution for purposes of determining HCE status is/are TRUE?

    I. Stock is attributed from child to parent.
    II. Stock is attributed from spouse to spouse.
    III. Stock is attributed from grandchild to grandparent.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

10. All of the following statements regarding HCE determination are TRUE, EXCEPT:

    A. Ownership in the lookback year has no impact on an employee's HCE status.
    B. Ownership in the current year has an impact on an employee's HCE status.
    C. Compensation in the lookback year has an impact on an employee's HCE status.
    D. Compensation in the current year has no impact on an employee's HCE status.
    E. Compensation is not considered when applying the ownership test for HCE determination purposes.

See next page for answers to the true/false and sample test questions.

Section 4.07: Solutions to True or False Questions

1. True.
2. False. The determination year for HCE purposes is the current plan year. The 12-month period immediately preceding the plan year is known as the lookback year.
3. True.
4. False. Stock ownership is attributed from parents, spouses and lineal descendants. Attribution does not extend to siblings.
5. True.
6. False. Employees who have not attained age 21 may be excluded from the top-paid group determination.
7. False. A 5 percent owner for purposes of determining who is an HCE is an individual who owns more than 5 percent of the business.
8. False. Employees who have been employed less than six months may be excluded from the top-paid group determination.
9. False. For the 2018 calendar year, employees earning more than $120,000 in 2017 will be considered HCEs. However, HCE determination consists of two tests: the compensation test and the 5 percent owner test so those meeting the compensation test may not be the only HCEs. Any employees who are 5 percent owners in either 2017 or 2018 would also be considered HCEs regardless of their compensation.
10. False. Anne is considered owning 100 percent of ABC Company due to attribution from her father. This stock is not attributed again to her spouse, because that would be double attribution. However, Mark could be an HCE under the compensation test.

Section 4.08: Solutions to Sample Test Questions

1. The answer is **E**. An employee is considered an HCE if he or she satisfies either the 5 percent owner test or the compensation test. The employee need not satisfy both tests to be an HCE.
2. The answer is **D**. The IRC §318 attribution rules apply when determining HCEs. Note: An employee who owns 5 percent of the employer fails to satisfy the 5 percent owner test because the 5 percent owner test is only satisfied if the employee owns more than 5 percent of the employer at any time during the determination year or the lookback year.
3. The answer is **B**. For HCE determination, there is attribution from grandchildren to grandparents, but there is no attribution from grandparents to grandchildren.
4. The answer is **A**. The calendar year data election applies only to determine the lookback year for the compensation test and does not apply to determine the HCEs under the 5 percent owner test.
5. The answer is **C**. To satisfy the 5 percent ownership test, an employee would need to own more than 5 percent of the business in either the prior year (2017) or the current year (2018). Employees A and B each own more than 5 percent. In addition, Employee D is considered to own more than 5 percent due to attribution from his or her spouse, Employee A. Employees C and E own exactly 5 percent and do not meet the 5 percent owner test. To satisfy the compensation test, an employee must earn more than $120,000 in the lookback year (2017). Only Employee A satisfies this requirement.
6. The answer is **D**. To satisfy the 5 percent ownership test, an employee must own more than 5 percent of the business in either the prior year (2017) or the current year (2018). Employees A owns more than 5 percent in 2017 and 2018. Employee B is considered to own more than 5 percent due to attribution from his or her spouse, Employee A. Employees C owned more than 5 percent in 2017. Employee E s considered to own more than 5 percent due to attribution from his or her parent, Employee A. There is no ownership attributed to siblings so Employee D has no ownership

interest. To satisfy the compensation test, an employee must earn more than $120,000 in the look-back year (2017). None of the employees satisfied this requirement.

7. The answer is **C**. When determining HCEs using the top-paid group election, employees may not be excluded from consideration simply because they are 5 percent owners.
8. The answer is **B**. Employees under age 21, employees who have not completed six months of service and employees who normally work less than six months per year may be excluded. Therefore, the top-paid group must include at least 80 employees (500 - 15 - 75 - 10 = 400) x 20%.
9. The answer is **E**. All of the statements are true.
10. The answer is **A**. Ownership in the lookback year does have an impact on an employee's HCE status. The 5 percent owner test is satisfied if the employee owns more than 5 percent of the employer at any time during the current plan year or during the lookback year.

Chapter 5:
Key Employees and Top-Heavy Plans

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Section 5.01: Key Terms

- 1 percent owner test
- 5 percent owner test
- Determination date
- Determination period
- Employer
- Former key employee
- Key employee
- Non-key employee
- Officer test
- Permissive aggregation group
- Related rollover
- Required aggregation group
- Six-year graded vesting
- Three-year cliff vesting
- Top-heavy plan
- Unrelated rollover

Section 5.02: Introduction

In 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act (TEFRA), which included the top-heavy rules. The purpose of these rules was to increase compliance requirements for plans that mostly favored a select group of individuals who controlled the plan sponsor. The top-heavy rules generally provide additional benefits for the rank-and-file participants and faster overall vesting for defined benefit plans, forcing the plan to provide somewhat more generous benefits than might be the case under the normal plan qualification requirements.

As a result, a plan administrator must determine each year whether a plan is top-heavy, and, if it is, apply the additional requirements. The determination of top-heavy status requires the plan administrator to do the following:

- Identify who are a select group of individuals (called key employees);
- Determine whether the plan is top-heavy by analyzing the level of benefits provided to those key employees as a percentage of total benefits; and
- Subject the plan (if it is top-heavy) to the more favorable benefit and vesting structures.

The top-heavy rules are found in Internal Revenue Code (IRC) §416, and the Treasury has published regulations to that IRC Section (Treas. Reg. §1.416-1). IRC §401(a)(10)(B) makes compliance with IRC §416 a qualification requirement. Therefore, a failure to comply with the top-heavy rules may subject the plan to disqualification.

This chapter will define a top-heavy plan and key employees, outline how top-heavy status is determined, and describe the ramifications of top-heavy status and necessary steps for compliance.

Section 5.03: What Is a Top-Heavy Plan?

Generally, a **top-heavy plan** is one in which the value of the account balances (for defined contribution plans) and the present values of accrued benefits (PVABs, for defined benefit plans) for key employees exceed 60 percent of the total of such account balances or PVABs in the plan. To make this determination, an administrator must:

1. Identify who is the employer for the plan(s) being examined;
2. Determine the date as of which top-heavy status must be determined for the employer's plans for the plan year at issue (i.e., the determination date);
3. Determine which employees are key employees, former key employees and non-key employees;
4. Identify the plans that must be considered in the analysis;
5. Determine the account balances and/or PVABs for all included employees;
6. Determine the percentage of the total value of the account balances and/or PVABs that belong to the key employees (i.e., the top-heavy ratio); and
7. Identify whether the top-heavy ratio exceeds 60 percent.

Section 5.04: Who Is the Employer?

The top-heavy determination must be made with regard to all companies that together constitute the **employer**. This includes the plan sponsor, plus any other company that is a member of a controlled group or affiliated service organization that includes the plan sponsor (i.e., related employers).

Section 5.05 Determination Date

All of the top-heavy determinations, including whether an employee is a key employee and what account balances are reviewed to see if the plan is top-heavy, are based on data for the determination period. The **determination period** is the plan year that contains the determination date.[1]

Usually, the **determination date** is the last day of the prior plan year.[2] However, for the first plan year, the determination date is the last day of that first plan year.

EXAMPLE 5-1. Determination Date. The Farmer Company establishes a profit sharing plan effective January 1, 2016. The plan year is the calendar year.

The determination date for the first plan year (i.e., January 1, 2018 through December 31, 2018) is the last day of the plan year (December 31, 2018).

The determination date for the second plan year (i.e., January 1, 2019 through December 31, 2019) is the last day of the prior plan year (i.e., December 31, 2018). Therefore, the top-heavy determination as of December 31, 2018, will apply for both the first and second plan years.

Section 5.06: Who Is a Key Employee, Former Key Employee and Non-Key Employee?

Because top-heavy testing involves a comparison between benefits of key employees and those of the other participants, we must determine who is key and who is not.

It is important to note that the determination of key employees does not apply to the various nondiscrimination tests for qualified plans. Do not confuse the key employee determination needed for top-heavy testing with the HCE determination needed for nondiscrimination testing. HCE determination was discussed in chapter 4.

FACTORS THAT DETERMINE A KEY EMPLOYEE

Key Employee Tests

An employee must satisfy at least one of three tests to be considered a **key employee**:

The 5 Percent Owner Test

An employee must own *more than* 5 percent of the employer (or more than 5 percent of a related employer) to satisfy the **5 percent owner test**. No minimum compensation is required for a person to be a key employee under this test.

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[1] IRC §416(i)(1).
[2] IRC §416(g)(4)(C).

For example, even if a 10 percent shareholder receives compensation of only $25,000 for a plan year, he or she is a key employee.

The 1 Percent Owner Test

An employee satisfies the **1 percent owner test** if the employee both:

- owns *more than* 1 percent of the employer (or more than 1 percent of a related employer); and
- has annual compensation *in excess of* $150,000. This $150,000 compensation requirement is not indexed for cost-of-living increases.

For purposes of this test, a person may be considered to own part of the company that is really owned by someone else. This is called attribution of ownership. Under this attribution, an individual is considered to own stock that is owned by:

- His or her spouse (unless legally divorced, legally separated, or meet the spousal exception).
- His or her children or grandchildren. Note that the age of the children and grandchildren is irrelevant.
- His or her parents.
- A partnership, to the extent that the individual is a partner in the partnership. In other words, if someone is a 50 percent partner, the partner is considered to own 50 percent of the portion of any company owned by the partnership.
- An estate, to the extent that the individual is a beneficiary of the estate. In other words, if someone is the beneficiary of 25 percent of an estate, then that beneficiary is considered to own 25 percent of any company owned by the estate.
- A trust (other than a qualified plan trust) in which the individual is a beneficiary, in proportion to his or her actuarial interest, or to the extent that he or she is considered to be the owner of the trust under the rules relating to trusts.
- A corporation, to the extent that the individual is a shareholder of the corporation, but only if his or her ownership interest is at least 5 percent of the corporation.[3]

The Officer Test

An employee satisfies the officer test if the employee both:

- is an officer; and
- satisfies the compensation requirement.

The compensation requirement is that the officer must earn more than $130,000 during the testing period. This amount is subject to cost-of-living adjustments (COLA) in $5,000 increments. Compensation requirements for recent years are:

Year	Amount
2010	$160,000
2011	$160,000
2012	$165,000
2013	$165,000
2014	$170,000
2015	$170,000
2016	$170,000
2017	$175,000
2018	$175,000

[3] IRC §318(a), as modified by IRC §416(i)(1)(B)(iii).

There is a limit on how many officers may be considered to be key employees in a given year. The maximum is the greater of:

- 10 percent of the number of employees; or
- Three.

However, no more than 50 officers are treated as key employees, even if the 10 percent cap is greater than 50.[4]

When the number of potential key employees due to the officer test is being determined, if the 10 percent number is not a whole number, the limit is increased to the next whole number.[5] For example, if a company has 43 employees, 10 percent of 43 employees is 4.3, so the maximum number of officers who could be key employees because of this test is five.

Once the includible number of officers is determined, one must identify which officers are included. If there are more officers than the maximum number determined above, the officers are ranked by compensation. The highest paid officers, up to the number that are includible, are the key employees.

Note that it is possible for an individual who is an officer to be a key employee under the ownership test. For purposes of ranking officers by compensation and determining which are key, the fact that someone may be a key employee because of stock ownership is disregarded.

EXAMPLE 5-2. Determination of Officers. ABC Company has six officers who satisfy the compensation requirement. They are:

Officer	Compensation
Shayna	$250,000
Wade	$225,000
Ossie	$210,000
Emily	$205,000
Rose	$190,000
Price	$180,000

The total number of employees in the company is 35, so the 10 percent limit on includible officers is four (10 percent of 35 is 3.5; the includible number is increased to the next whole number, which is four). This means that Shayna, Wade, Ossie and Emily are key employees due to their officer status.

If Shayna owns 80 percent of the company, the fact that she is already a key employee based on her stock ownership does not cause her to be disregarded for the officer test. Similarly, if Rose owned 10 percent of the company, the fact that she is a key employee due to the 5 percent ownership test would not cause her to be included as one of the four officers for purpose of the officer test.

Whether someone is or is not an officer is not determined solely by title. A person's status as an officer is a facts and circumstances determination, taking into account such indicators as the source of the employee's authority, the term for which the employee is elected or appointed and the nature and extent of the employee's duties. Treasury Regulations indicate that an officer is someone who is an administrative executive in regular and continued service with the employer, and not someone who is employed for a special and single transaction. If someone has a nominal title of an officer but very little authority (such as many bank officers), that person is not an officer for top-heavy determination purposes. Conversely, someone with no title who fulfills the role of an administrative executive would be an officer for top-heavy purposes.[6]

Compensation Used

Compensation for purposes of determining whether the threshold for the officer test is reached is IRC §415 compensa-

[4] IRC §416(a)(5)(A).
[5] Treas. Reg. §1.416-1, T-14.
[6] Treas. Reg. §1.416-1, Q&A T-13.

tion, as defined by the plan.[7] A plan may use one of three prescribed definitions for this purpose:

- current includible compensation;
- W-2 compensation; or
- compensation for Federal Insurance Contributions Act (FICA) withholding purposes.

Even though they are not included in taxable income, elective deferrals and catch-up contributions to 401(k) plans, cafeteria plans, 403(b) programs, SIMPLE IRAs, SARSEPs, section 457 plans and qualified transportation fringe benefit programs are includible in IRC §415 compensation, regardless of which of the three above definitions is used.

WHAT IS A FORMER KEY EMPLOYEE?

A former key employee is an individual who was a key employee at some time in the past, but no longer meets the requirements to be a key employee.[8]

WHAT IS A NON-KEY EMPLOYEE?

A **non-key employee** is any employee who is neither a key nor former key employee.[9]

Section 5.07: When Is a Plan Top-Heavy?

Generally, a plan is top-heavy if the top-heavy ratio exceeds 60 percent.[10] This ratio is determined as of the determination date. The top-heavy ratio is equal to the total account balances and present values of accrued benefits accumulated for all key employees (adjusted, as outlined below), divided by such total for all participants includible in the test.

PLANS THAT MUST BE CONSIDERED IN DETERMINING TOP-HEAVY STATUS

If the employer maintains more than one plan, the plans must be aggregated for determining top-heavy status if they are part of a required aggregation group. If they are not part of a required aggregation group, the plans are tested separately for top-heavy purposes. However, plans that are not included in the required aggregation group may be permissibly aggregated into the group under certain circumstances.

If a required aggregation group's top-heavy ratio exceeds 60 percent, every plan in the group is considered to be top-heavy, even if the plan would not be top-heavy if it was examined separately. Similarly, if the required aggregation group's top-heavy ratio is 60 percent or less, every plan in the group is considered not to be top-heavy, even if such plan would clearly be top-heavy if it was examined separately.

Required Aggregation Group

A required aggregation group consists of:

- Each plan in which at least one key employee participates; and
- Any other plan that enables the plan with the key employee to satisfy nondiscrimination testing under IRC §401(a)(4) or coverage testing under IRC §410(b).[11]

[7] IRC §416(i)(1)(D), which references IRC §414(q)(4), which in turn references IRC §415.
[8] IRC §416(g)(4)(B).
[9] IRC §416(i)(2); see also IRC §416(g)(4)(B).
[10] IRC §416(g)(1).
[11] IRC §416(g)(2)(A)(i).

For this purpose, any qualified plan or SEP is subject to aggregation.[12] On the other hand, SIMPLE IRA or SIMPLE 401(k) plans are not subject to aggregation for top-heavy purposes, as they are both exempt from the top-heavy rules. If a SIMPLE 401(k) plan is later converted to a regular 401(k) plan or is replaced by another type of qualified plan, the modified or replaced plan would be includible in the required aggregation group if it covered a key employee.

EXAMPLE 5-3. Required Aggregation Group. The Law Partnership sponsors two 401(k) plans: one that covers the partners and staff, and the other, which covers only associate attorneys. None of the associates is an officer. The plans separately meet coverage and nondiscrimination testing. Because none of the associates is a key employee, the two plans are not part of a required aggregation group and may be tested separately for top-heavy purposes.

EXAMPLE 5-4. Associate Becomes Key Employee. Joe, an associate in the Law Partnership, is promoted to become one of five equal partners as of January 1, 2018. Joe now owns 20 percent of the firm, so he is a 5 percent owner and, thus, a key employee. Joe is a participant in the 401(k) plan that covers associates, and no one remembers to have his account transferred to the partner plan. Because the associate plan now covers a key employee, the associate plan has become a part of the required aggregation group and must be tested together with the partner plan for top-heavy purposes.

EXAMPLE 5-5. Different Key Employees Participate in Different Plans. Company Y sponsors two plans—a defined benefit plan for Division A and a defined contribution plan for Division B. Pete, a key employee, participates in the defined benefit plan, but not the defined contribution plan. Sally, also a key employee, participates only in the defined contribution plan. Both plans are part of the required aggregation group, because key employees participate in each plan. It is not necessary for the same key employee to participate in both plans for them to be part of a required aggregation group.

If You're Curious . . .

What does it mean for a key employee to participate for purposes of this rule? The regulations do not specify. However, under the reporting rules for Form 5500, an individual is considered to be a participant if he or she is an employee who is or may become eligible to receive a benefit of any type from an employee benefit plan. This would mean that any individual who has a claim to a benefit (such as someone who has an account balance) or who could receive an allocation in the future (such as an active participant who has not been excluded from plan participation) is a participant. However, this definition is based on an ERISA section[13] and the issue of participation in the top-heavy context is a tax issue. Nonetheless, in the absence of other guidance, ensuring that no key employee has either a current balance or a right to a share in contribution or forfeiture allocations is the safest approach.

Key employee participation in both plans is not the only situation in which plans become part of a required aggregation group for top-heavy purposes. If any other plan enables the plan with the key employee to satisfy nondiscrimination testing under IRC §401(a)(4) or coverage testing under IRC §410(b), those plans are part of a required aggregation group. How does one plan enable another to pass coverage or nondiscrimination testing? This is best illustrated by an example.

EXAMPLE 5-6. Plan Helping Another Plan Pass Coverage. ABC Corporation sponsors two profit sharing plans. Plan A covers the owners of the business and Plan B covers the rest of the employees. Plan B does not cover any key employees or HCEs. Plan B automatically satisfies the IRC §410(b)

[12] IRC §416(i)(6).
[13] ERISA §3(7).

coverage rules, because it covers no HCEs. However, in order for Plan A to pass the coverage requirements of IRC §410(b), it must be aggregated with Plan B. Because Plan B is helping Plan A to pass coverage, it is part of the required aggregation group with Plan A for top-heavy purposes.

It is important to note which plan is being helped to pass coverage by the aggregation. In order for Plan B to be included in the required aggregation group, it must be helping Plan A (the plan that has the key employees) to pass coverage. If Plan A can pass coverage without the assistance of Plan B, Plan B would not be in the required aggregation group.

EXAMPLE 5-7. Plans Satisfy Coverage and Nondiscrimination Separately. Plan A, sponsored by DEF Corporation, covers all key employees plus several non-key employees. Plan B covers only non-key employees. Plan A satisfies both coverage and nondiscrimination requirements on its own. Plan B is not part of the required aggregation group because Plan B covers no key employees and is not needed to assist Plan A to satisfy coverage or nondiscrimination rules.

If You're Curious . . .

Some plans or plan features must be disaggregated for coverage and nondiscrimination testing. For example, 401(k) features are tested separately from matching features and profit sharing features for coverage purposes. Similarly, some plans disaggregate participants who are otherwise excludable employees (i.e., have completed less than one year of service or are younger than age 21) for purposes of coverage and nondiscrimination testing. This type of disaggregation is disregarded for top-heavy purposes. These segments of the plan would be aggregated for top-heavy purposes.

IRC §410(b) also requires that ESOPs be tested for coverage separately from other plans. Even though an ESOP is mandatorily disaggregated for coverage purposes, if the ESOP covers a key employee and a key employee participates in another plan of the employer, both the ESOP and the other plan are aggregated for top-heavy purposes. Finally, plans of qualified separate lines of business (QSLOBs) of a single employer must be aggregated for top-heavy testing purposes if they each cover a key employee.

If a plan is a multiple employer plan—that is, a plan that covers more than one company and not all the companies are related to each other—top-heavy rules are applied separately to the different companies.

EXAMPLE 5-8. Multiple Employer Plan. Plan X covers employees of Company 1, Company 2 and Company 3. Company 1 is the 100 percent parent of Company 2 (so the two companies are related and constitute one company for top-heavy purposes). Company 3 is owned 50 percent by Company 1, and does business in a completely unrelated field. Therefore, Company 3 is part of neither a controlled group nor an affiliated service group with Companies 1 and 2. The top-heavy determination will be made separately for the portion of Plan X covering the Company 3 employees, while the portion of Plan X covering Company 1 and 2 employees will be aggregated.[14]

If a terminated plan is not fully paid out (or if account balances must be added back), that plan must be aggregated with active plans if it is part of the required aggregation group.[15]

Permissive Aggregation of Plans

Two plans that are not part of a required aggregation group may be permissively aggregated. The purpose of permissive

[14] Treas. Reg. §1.416-1, Q&A G-2.
[15] Treas. Reg. §1.416-1, Q&A T-4.

aggregation is to show that the combined plans are not top-heavy.

Plans may be part of a permissive aggregation group if:

- They are not required to be aggregated because of the required aggregation group rules; and
- They satisfy coverage testing under IRC §410(b) and nondiscrimination testing under IRC §401(a)(4) if they are considered together.[16]

The effect of permissively aggregating plans is to reduce the top-heavy ratio. If the top-heavy ratio for permissively aggregated plans is 60 percent or less, none of the plans is top-heavy, even if a plan (or the required aggregation group of plans) would have a top-heavy ratio of more than 60 percent if it was tested separately.

Because of the nature of permissive aggregation, no employer can be forced by the IRS to aggregate plans. Therefore, plans are permissively aggregated only when to do so will cause the group not to be top-heavy.

EXAMPLE 5-9. Permissive Aggregation. Plan A and Plan B are not part of a required aggregation group. Each plan is able to satisfy coverage and nondiscrimination testing without regard to the other. However, Plan A (which contains all the key employees of the employer) is top-heavy. Plan B has a top-heavy ratio of 0 percent, because no key employees participate in that plan.

The benefits provided in Plan A and Plan B are such that, if the two plans were aggregated for nondiscrimination testing, they would satisfy that testing together. Furthermore, if the two plans were tested together, coverage testing also would be satisfied.

The employer decides to permissively aggregate Plan A and Plan B for top-heavy purposes. When the benefits of the participants in both plans are considered together, the top-heavy ratio is reduced to 58 percent. Therefore, due to permissive aggregation, neither Plan A nor Plan B is top-heavy.

If the combined top-heavy ratio was 62 percent, the employer would elect not to aggregate Plan B with Plan A and would therefore avoid subjecting Plan B to the top-heavy plan requirements.

Determination Date for Aggregated Plans

If more than one plan is included in the top-heavy ratio because of these aggregation rules, the value of the accrued benefits is first determined separately for each plan. Then, the values are added together to calculate the top-heavy ratio. Values for determination dates that fall within the same calendar year are used to determine the top-heavy ratio.

EXAMPLE 5-10. Determination Date of Aggregated Plans. Corporation X maintains a defined benefit plan with a June 30 year end and a 401(k) plan with a calendar plan year. These plans are part of the required aggregation group for top-heavy purposes, because each covers at least one key employee. Corporation X wants to know if the plans are top-heavy for the plan years ending in 2018.

The PVAB for the defined benefit plan is calculated as of the June 30, 2017 determination date (i.e., the last day of the plan year before the 2017-2018 year). The account balances are determined for the 401(k) plan as of December 31, 2017 (the last day of the 2017 plan year). These values are added together to determine the top-heavy ratio. That ratio will apply to determine the top-heavy status of the defined benefit plan for the plan year beginning July 1, 2017 and ending June 30, 2018. The ratio will determine the top-heavy status of the 401(k) plan for the 2018 calendar year

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[16] IRC §416(g)(2)(A)(ii).

VALUES INCLUDED IN THE TOP-HEAVY RATIO

Contributions in a Defined Contribution Plan

The timing of when to include contributions in the top-heavy ratio depends upon the source of the contributions.

Employer Contributions

The timing of when to include employer contributions in the top-heavy ratio depends upon the type of plan (i.e., pension plan or nonpension plan).

Pension plans use accrual method. If the defined contribution plan is a pension plan (i.e., money purchase pension or target benefit pension), employer contributions due as of the determination date under the minimum funding requirements are included in the account balance, even if the contributions were not deposited by that date. In other words, the value of a pension plan account is determined on an accrual method of accounting.

Nonpension plans use cash method. If the defined contribution plan is not a pension plan (i.e., profit sharing, 401(k) or stock bonus plan), only employer nonelective contributions actually made by the determination date are included. In other words, the value of a nonpension account is based on a cash method of accounting. This method is common for daily valued plans. However, if the plan uses balance-forward valuation, regular participant statements may be based on the accrual method for employer nonelective contributions and the administrator must back out contributions not made by the determination date for top-heavy purposes.[17]

If the determination date and the valuation date are different, employer nonelective contributions actually made after the valuation date, but before the determination date, must be included in the account for top-heavy determination purposes. However, employer nonelective contributions allocated as of the determination date that are contributed after the determination date are excluded for top-heavy determination purposes.

Exception for first plan year of a nonpension plan. There is an exception to this rule for the first year of the plan. In such year, employer nonelective contributions made after the close of the plan year but for the first year are included in the account balance for top-heavy purposes. Because the same determination date is used for the second plan year, it is presumed that the accrual method of accounting is appropriate for that top-heavy determination, as well.

If You're Curious . . .

Notwithstanding the language of the Treasury Regulations, IRS representatives put a new spin on the inclusion of employer nonelective contributions deposited after the plan year in the top-heavy ratio. At the 2002 ASPPA Annual Conference in the Q&A Session, the IRS representatives suggested that the account balance may reasonably be interpreted to include amounts contributed after the determination date, but allocated as of such date under the plan. While this interpretation contradicts the wording in the Regulations, it appears that the IRS would unlikely raise an issue if a nonpension plan used the accrual method instead of the cash method for top-heavy determination purposes.

After-Tax Employee Contributions and Elective Deferrals

Accrued benefits attributable to elective deferrals, whether pre-tax deferrals or after-tax designated Roth contributions, and after-tax employee contributions are included in the top-heavy ratio. However, deemed IRAs are excluded.

Catch-up Contributions

A 401(k) plan may allow participants who have reached age 50 (or will do by the end of the calendar year) to make ad-

[17] Treas. Reg. §1.416-1, T-24.

ditional elective contributions, known as catch-up contributions. According to Treasury Regulations, catch-up contributions are disregarded for top-heavy purposes only for the plan year in which they are made. Catch-up contributions made for prior plan years are taken into account for the top-heavy ratio.[18]

EXAMPLE 5-11. Catch-up Contributions in the Top-Heavy Ratio. Jamie, a 56-year-old participant in the C Company 401(k) Plan contributed catch-up contributions in 2015, 2016 and 2017 in the amounts of $4,000, $5,000 and $5,000, respectively. As of the December 31, 2017, plan year end, Jamie's account balance in the 401(k) plan was $100,000, including the $14,000 of catch-up contributions, plus $500 of earnings on the catch-up contributions.

For the calendar year 2018 top-heavy ratio, contributions made for the current year (that is, 2018) are not taken into account. However, because the top-heavy ratio is determined as of December 31, 2017 (i.e., the determination date is in the prior year), nothing in the account as of December 31, 2017 is disregarded. Therefore, Jamie's account for determining the top-heavy ratio is $100,000.

On the other hand, if the $100,000 account balance as of December 31, 2018, included a $5,500 catch-up contribution made during 2018, the account balance for the December 31, 2018, determination date would be $94,500 ($100,000 minus the current year catch-up contribution).

Adding Back Distributions

Certain distributions paid to participants are added back to participants' accounts for purposes of determining the top-heavy ratio. In general, any distributions made during the 12-month period ending on the determination date are added back and included in the account balance.[19] This lookback on distributions applies for both:

a. terminated participants who received distributions of all or part of their accounts or benefits and who had at least one hour of service during the plan year including the distribution date; and
b. current participants who took in-service distributions.

However, if a distribution is made for a reason other than severance from employment, death or disability, the lookback is extended and the distribution is added back if it occurred within the five-year period ending on the determination date.[20]

Because the IRC uses the "severance from employment" language, any termination (even if it is to perform the same service for a buyer of the Company's assets) makes the one-year lookback rule applicable. However, note that a termination of the plan may create in-service withdrawals, which are subject to the five-year rule.

EXAMPLE 5-12. Distribution Added Back. The ABC Company is determining its top-heavy ratio for the 2018 calendar year. The determination date is December 31, 2017. The account balances as of December 31, 2017, total $1,500,000. In addition, the following distributions have been made during the past five years:

Participant	Reason for Distribution	Amount Distributed	Date Distributed
Andy	Termination - 4/1/2013	$10,500	6/15/2013
Barbara	Hardship	$8,250	9/24/2014
Courtney	Termination - 10/15/2014	$52,000	1/3/2015

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[18] Treas. Reg. §1.414(v)-1(d)(3)(i).
[19] IRC §416(g)(3), Treas. Reg. §1.416-1, T-30 and T-31. Note, however, that the regulations reflect pre-EGTRRA law, which included a five-year lookback on distributions, rather than the current law one-year lookback.
[20] IRC §416(g)(3)(B).

Participant	Reason for Distribution	Amount Distributed	Date Distributed
David	In-service distribution of 401(k) deferrals	$25,000	3/17/2016
Ellen	Termination - 7/1/2017	$4,000	11/20/2017

Distributions due to termination: Only those made during the 12-month period ending on the determination date (i.e., January 1, 2017, through December 31, 2017) to participants with at least one hour of service in that period are counted. Ellen's distribution is added back, because her distribution was during the prior 12 months and she worked during 2017. Andy's and Courtney's are disregarded, because both terminated well before 2017 and received their distributions in pre-2017 years.

Distributions due to reasons other than severance from employment, retirement or disability: Barbara and David received in-service withdrawals within the last five years (i.e., January 1, 2013, through December 31, 2017). Therefore those distributions are added back.

The total amount used in the top-heavy ratio is $1,500,000, plus $8,250 (Barbara), $25,000 (David) and $4,000 (Ellen), for a total of $1,537,250.

If You're Curious . . .

Distribution of Excess Contributions, Excess Aggregate Contributions and Excess Defferals

The inclusion or exclusion of distributions from a 401(k) plan relating to failed ADP tests (excess contributions) or ACP tests (excess aggregate contributions) or exceeding the annual limit on elective deferrals under IRC §402(g) (excess deferrals) is not addressed in regulations or other Treasury guidance. However, the IRS informally stated at the 2002 ASPPA Annual Conference Q&As that distributions of excess contributions or excess aggregate contributions due to failed nondiscrimination tests are considered to be in-service withdrawals and, as such, are subject to the five-year lookback rule. On the other hand, the IRS representatives at the conference did not discuss whether distributions of excess deferrals are included in the top-heavy ratio. Because excess deferrals are not considered to be annual additions under Treasury Regulations if they are distributed on or before April 15th of the year following contribution, many practitioners believe that they also are excluded from the top-heavy ratio.

Rollovers

Are amounts rolled over into a plan (or rolled out of a plan) considered in the top-heavy ratio? It depends on whether the rollover is a related rollover or an unrelated rollover.

Related Rollovers

A related rollover is a rollover or transfer either:

- made to another plan maintained by the same or a related employer; or
- made without the participant's election (such as a transfer made pursuant to a merger of two plans).[21]

For example, suppose an employer terminates its money purchase pension plan and gives participants an option to roll over their benefits to the new 401(k) plan it establishes. Alternatively, the participants may roll over their benefits to an IRA or take them in cash, subject to withholding. When some participants elect to roll over their benefits to the new 401(k) plan, these are related rollovers. Even though the transfer was subject to the participant's own election, it was

[21] Treas. Reg. §1.416-1, Q&A T-32.

made to a plan of the same employer.

If a rollover is related, the plan making the distribution does not count the distribution in its top-heavy ratio, but the recipient plan includes the rollover account in its ratio.

EXAMPLE 5-13. Related Rollover. Company X acquires the assets of Company Y. Pursuant to the sale, Company X agrees to have the account balances in Company Y's 401(k) plan directly transferred to Company X's 401(k) plan. These are related transfers, because they are made by the direction of the employer, without any election being made by the participants.

As of the determination date following the transfer, the Company Y plan will not count these distributions (i.e., the accounts in the top-heavy ratio will not include the transferred amounts), but they will be included in the Company X plan. Note that the fact that Company X and Company Y are unrelated is not relevant, because the related nature of the rollover is determined by the fact that it is being made without an election of the participants.

If an employer sponsored a SEP and permits the participants to roll the accounts from the SEP into the company's qualified plan, those are related rollovers. Furthermore, if the SEP and the qualified plan are maintained at the same time, they are part of a required aggregation group and the balances in the SEP must be added into the top-heavy ratio. Note, however, that a SEP is permitted to elect to exclude earnings when including the account in the top-heavy ratio. It appears likely that the exclusion of earnings does not apply if the SEP is transferred or rolled over to the qualified plan.

On the other hand, SIMPLE IRAs are specifically excluded from the top-heavy rules. Therefore, a rollover from a SIMPLE IRA is treated as an unrelated rollover and is not included in the top-heavy ratio of the recipient plan.

Unrelated Rollovers

An unrelated rollover is a rollover or transfer that is <u>both</u>:

- elected by the participant; <u>and</u>
- made to a plan maintained by another, unrelated employer.

In the case of an unrelated rollover, the distributing plan includes the amount as part of the accrued benefit (that is, as a distribution) and the plan receiving the rollover excludes the amount from the accrued benefits. Note, however, that unrelated rollovers or transfers received before January 1, 1984, must be included in the top-heavy ratio of the recipient plan.

If the rollover is not related, the plan making the distribution treats the amount like any other distribution and adds it back if it is within one year (if the participant received the distribution by virtue of severance from employment, death or disability) or within five years (if it is an in-service withdrawal).

EXAMPLE 5-14. Unrelated Rollover in Asset Acquisition. Assume the same facts as in **EXAMPLE 5-13**, except that Company X does not agree to receive a direct transfer of accounts from Plan Y. Instead, Company Y terminates its plan and offers distributions to the participants, who include some former employees of Company Y that now work for Company X. Company X permits these employees to roll over their distributed balances to Plan X. In this case, the rollovers are unrelated, because the employees elected the rollover, and Company X, a purchaser of assets, is unrelated to Company Y.

EXAMPLE 5-15. Unrelated Rollover. Roz is hired by Company Q. She is eligible for a lump-sum distribution from her prior employer's plan and elects a direct rollover of that distribution into Company Q's plan. Roz's prior employer and Company Q are not related under IRC §414. Because the companies are not related and the rollover is made at Roz's election, the rollover is an unrelated rollover. Therefore, Roz's balance attributable to her rollover is disregarded by Company Q's plan in

determining whether it is top-heavy.

Accounts of Former Employees That Are Still in the Plan

Suppose a participant terminates employment with the plan sponsor and elects to leave his or her account in the plan indefinitely. The top-heavy ratio does not include the value of the former employee's account or accrued benefit if he or she has not been credited with at least one hour of service during the lookback period. The lookback period for this purpose is the 12-month period ending on the determination date.[22]

Similarly, if the former employee's account or accrued benefit would have been disregarded during a given determination period, any distribution to the former employee during that period is also disregarded.

EXAMPLE 5-16. Terminted Employee With Account Balance in the Plan. Teri terminates employment on April 1, 2017. Her account balance remains in her employer's profit sharing plan for three years before she consents to a distribution from the plan. To determine if the plan is top-heavy for the 2018 year, the determination date is December 31, 2017. Because Teri had at least one hour of service during the 12-month period ending on December 31, 2017, her account balance is counted in the top-heavy ratio. However, for the 2019 year, the determination date is December 31, 2018. Teri did not work for the company during 2018, so she has no hours of service. As a result, Teri's account is excluded from the top-heavy ratio, even if it is still in the plan at that time.

EXAMPLE 5-17. Terminted Employee With Distribution. Suppose in the prior EXAMPLE 5-16 that Teri received a cash-out distribution in June 2017. For the 2018 plan year, Teri's distribution is added back into the top-heavy ratio, because she has an hour of service in the one-year period ending on the December 31, 2017 determination date. However, for the 2019 year, Teri's distribution is not included because the distribution did not take place within one year of the determination date of December 31, 2018 and Teri did not have an hour of service during 2018.

EXAMPLE 5-18. Terminated Employee With Prior In-Service Withdrawal. Joel is a participant in a 401(k) plan. The plan has a December 31 plan year end. On June 1, 2015, Joel receives a hardship withdrawal from the plan in the amount of $4,000. On August 1, 2017, Joel terminates employment with the plan sponsor. He does not receive a distribution of his remaining account balance until July 2021.

To determine if the plan is top-heavy for the 2018 plan year, the determination date is December 31, 2017. Joel's hardship withdrawal was an in-service withdrawal and the five-year add-back of in-service withdrawals applies. Therefore, the $4,000 is included in the top-heavy ratio. Furthermore, as he had more than one hour of service for 2017, the balance of his account is also included in the top-heavy ratio. To determine if the plan is top-heavy for the 2019 year, the determination date is December 31, 2018. At that point, neither Joel's account balance nor his 2015 hardship withdrawal are taken into account, because Joel has not had an hour of service during the one-year period ending on the December 31, 2018 determination date.

Former Key Employees

The accrued benefit of a **former key employee** and distributions to a former key employee are excluded from both the numerator and the denominator of the top-heavy ratio—that is, it is like that person never existed. In other words, once someone has been a key employee, he or she may be treated in later years as a key employee (if he or she returns to being

[22] IRC §416(g)(4)(E).

key) or a former key employee, but never as a non-key employee.[23]

EXAMPLE 5-19. Former Key Employees. Reece owns an 8 percent interest in Corporation L. On June 30, 2017, he sells his stock to an unrelated individual. After the sale, Reece has no ownership, either directly or by attribution. Reece also is not an officer.

The plan year ends on September 30. For the plan year beginning October 1, 2017, the determination date is the last day of the prior plan year, September 30, 2017. Because Reece satisfied the 5 percent owner test during the plan year that includes the determination date (i.e., October 1, 2016, through September 30, 2017), he is a key employee as of the September 30, 2017, determination date and is included in the top-heavy ratio as a key employee.

For the next plan year, beginning October 1, 2018, Reece is now a former key employee, because, although key at one time, he no longer satisfies any of the key employee definitions. During the plan year beginning October 1, 2017, through September 30, 2018, Reece had no ownership interest and is not an officer. As a result, Reece is a former key employee and his accrued benefit is excluded from both the numerator and the denominator of the top-heavy ratio for the September 30, 2018, determination date, and any distributions that may have been made to him are also excluded.

If Reece should become an officer of Corporation L on July 1, 2020 (and has sufficient compensation to satisfy the officer test under the key employee definition), he would once again become a key employee. For the plan year that includes the determination date (i.e., October 1, 2019, through September 30, 2020), Reece would again be a key employee, and his account balance and any distributions would be added back into the top-heavy ratio.

SUMMARY OF VALUES INCLUDED IN THE TOP-HEAVY RATIO

Source	Include in Top-heavy Ratio?	Comments
Employer pension contributions	Yes	Include accrued contributions
Employer nonpension contributions	Yes	Include if contributed by the determination date
Catch-up contributions	Yes	Disregard those made for the plan year ending on the determination date; include any made for prior plan years
Employer contribution account balances	Yes	Includes matching contributions, nonelective contributions, QNECs, QMACs, forfeitures, etc.
Elective deferral account balances	Yes	
After-tax employee contribution account balances	Yes	
Deemed IRA account balances	No	
Distributions due to severance of employment, death or disability	Yes	Include if participant worked at least one hour during the determination year
In-service withdrawals made by active participants	Yes	Include if distribution occurred within the five-year period ending on the determination date.
Related rollover account balances	Yes	Included in recipient plan's top-heavy ratio

[23] IRC §416(g)(4)(B).

Source	Include in Top-heavy Ratio?	Comments
Unrelated rollover account balances	No	Not included in recipient plan's top heavy ratio (but considered a distribution from the distributing plan, so normal distribution add-back rules apply)
Former employees' account balances	No	Do not include if participant terminated prior to the determination year
Former key employees' account balances	No	May be included in future determination year if former key becomes a key employee again

THE TOP-HEAVY RATIO

Once the values to be included in the top-heavy ratio are determined, the ratio may be calculated. The numerator of the ratio is the total of the includible account balances and PVABs for the key employees. The denominator of the ratio is the total of the includible account balances and PVABs for all key and non-key employees. Remember that values for former key employees are disregarded for both the numerator and the denominator of the ratio.

$$\text{Top-heavy ratio} = \frac{\text{key employee includible account balances, PVABs and distributions}}{\text{includible account balances, PVABs and distributions for key and non-key employees}}$$

IS THE PLAN TOP-HEAVY?

The plan being tested is top-heavy if the top-heavy ratio is greater than 60 percent. If the required aggregation group is being tested, all plans in the group are top-heavy if the group is top-heavy. If a permissive aggregate group is being tested and the top-heavy ratio is 60 percent or less, none of the plans in the permissive aggregation group is top-heavy. If the ratio for the permissive aggregation group is more than 60 percent, the individual plans that are being permissively aggregated should be separately tested; if any permissively aggregated plan has an individual top-heavy ratio of 60 percent or less, it is not a top-heavy plan.

Section 5.08: Requirements for Top-Heavy Plans

When a plan is top-heavy, two main requirements become applicable. First, if the plan is a defined benefit plan, the vesting schedule must satisfy more stringent rules than those for non-top-heavy defined benefit plans. Second, non-key participants must receive minimum levels of contribution (in defined contribution plans) or benefit accruals (in defined benefit plans) during years in which the plan is top-heavy.

TOP-HEAVY VESTING SCHEDULES

Top-heavy plans have minimum vesting requirements. Vesting is discussed in Chapter 9.

MINIMUM ALLOCATIONS IN TOP-HEAVY DEFINED CONTRIBUTION PLANS

General Rule

As a general rule, a non-key employee's allocation under a top-heavy defined contribution plan must be at least 3

percent of compensation for the entire plan year.[24] If the participant's allocation is equal to or greater than 3 percent, then no further contribution is required to satisfy the top-heavy rules. But, remember, there might be other, unrelated reasons why a greater contribution may have to be provided [for example, if the plan is unable to satisfy the nondiscrimination testing requirements under IRC §401(a)(4), based on the amounts that have been allocated].

Compensation for purposes of determining top-heavy minimum allocations is IRC §415 compensation, as defined in IRC §415(c)(3) and the associated regulations.[25] The plan may use a different definition of compensation for allocations of employer contributions, so long as the allocation to any non-key employee is not less than 3 percent of IRC §415 compensation for the entire year. Compensation definitions are described in more detail in Chapter 7.

EXAMPLE 5-20. Profit Sharing Contribution Exceeds Top-Heavy Minimum. A profit sharing plan provides for a pro rata allocation of contribution based on compensation. Christopher's IRC §415 compensation for the plan year is $30,000. The plan is top-heavy. For the current plan year, the employer contributes an amount equal to 5 percent of eligible compensation. Christopher's allocation is 5 percent of $30,000, or $1,500. The top-heavy minimum allocation for Christopher is 3 percent of $30,000, or $900. Because his allocation exceeds the top-heavy minimum allocation, the plan satisfies the top-heavy requirements.

EXAMPLE 5-21. Profit Sharing Allocation Based on Compensation While a Participant. Roger becomes a participant in a top-heavy plan with a calendar plan year at mid-year—that is, on July 1st. Under the plan, allocations of the profit sharing contribution are based on compensation while a participant. Therefore, Roger's allocation is based on his compensation from July 1 through December 31, which is $15,000. The employer contributes an amount equal to 5 percent of eligible compensation, and Roger's share of that contribution is 5 percent of $15,000, or $750.

Roger's IRC §415 compensation for the entire plan year is $30,000. His top-heavy minimum allocation is 3 percent of the full plan year compensation, or 3 percent of $30,000, which is $900. The plan has not satisfied the top-heavy minimum allocation requirement because Roger's allocation was only $750. The plan will have to allocate another $150 to Roger's account to satisfy the requirement. If the plan has a failsafe provision, the employer will make up the $150 difference through an additional contribution to the plan on Roger's behalf. If not, some type of corrective measure will be needed.

EXAMPLE 5-22. Money Purchase Allocation Based on Base Salary. Each eligible participant in a money purchase pension plan receives an employer contribution allocation in an amount equal to 4 percent of compensation. Compensation is defined as base salary, i.e., excluding bonuses and overtime. Andrea, a non-key employee, has a base salary of $20,000. Her allocation for the plan year is 4 percent of $20,000, or $800. However, Andrea's bonuses and overtime for the plan year total $10,000. Her top-heavy minimum allocation is calculated on her total IRC §415 compensation of $30,000. The top-heavy minimum allocation for Andrea is 3 percent of $30,000, or $900. Because her allocation ($800) is less than the top-heavy minimum allocation ($900), the plan has not satisfied the top-heavy requirement.

EXAMPLE 5-23. Profit Sharing Allocatino Based on Taxable Compensation. A profit sharing plan allocates employer contributions based on a participant's net compensation (that is, compensation remaining after cafeteria plan contributions are subtracted). Turrell's net compensation for the plan year is $36,000. His cafeteria plan contributions for the year, which are used to purchase health in-

[24] IRC §416(c)(2).

[25] See Treas. Reg. §1.415(c)-2.

surance benefits, total $4,000. Turrell's IRC §415 compensation is $40,000 ($36,000 plus $4,000). The top-heavy minimum allocation is 3 percent of $40,000, or $1,200.

EXAMPLE 5-24. 401(k) Deferrals Excluded from Compensation. Suppose in EXAMPLE 5-23, the profit sharing plan includes a 401(k) arrangement. Turrell's elective deferrals to the 401(k) arrangement for the plan year were $2,000. The net compensation reflects Turrell's compensation after the 401(k) elective deferrals are deducted. Therefore, Turrell's IRC §415 compensation is $42,000 (that is, the $36,000 net compensation, plus elective deferrals of $2,000, plus cafeteria plan contributions of $4,000). The top-heavy minimum allocation is now 3 percent of $42,000, or $1,260.

If the plan has a short plan year, a top-heavy minimum must be satisfied for the short year, based on the IRC §415 compensation for that short-year period.

Exception to 3 Percent Allocation Rule

There is an exception to the 3 percent allocation minimum if all key employees have an allocation rate for the plan year (not the determination year) of less than 3 percent. In that case, the minimum benefit for that year for top-heavy allocation purposes is the highest allocation rate for any key employee.[26]

To determine the highest key employee allocation rate, the plan must take into account the amount of employer contributions and forfeitures allocated to each key employee for the plan year, and divide this amount by the key employee's IRC §415 compensation.[27] Earnings allocated to the key employee's account balance for the plan are not counted. Elective contributions made by the key employee to a 401(k) plan are included in determining the participant's allocation rate for this purpose.

On the other hand, elective contributions made by a key employee that are catch-up contributions are disregarded for this purpose.[28]

EXAMPLE 5-25. No Contribution for the Year. An employer does not contribute to its profit sharing plan for the current plan year. There also are no forfeitures allocated for that year. Because there are no allocations other than earnings, the highest key employee allocation rate is 0 percent. The top-heavy minimum allocation for the plan year is 0 percent.

EXAMPLE 5-26. Elective Deferrals Only. Suppose the plan in **EXAMPLE 5-25** includes a 401(k) arrangement. At least one key employee deferred 2 percent of his or her compensation for the plan year. The top-heavy minimum allocation is now 2 percent.

If, instead, one key employee deferred 3 percent or more of his or her compensation for the plan year, the top-heavy minimum allocation would be 3 percent.

If the employer maintains more than one top-heavy defined contribution plan, the plans are treated as a single plan to determine the highest key employee allocation rate.

EXAMPLE 5-27. Two Top-Heavy. An employer maintains two profit sharing plans, Plan X and Plan Y. Plan X covers all salaried employees and Plan Y covers all hourly paid employees. All but one of the key employees are covered by Plan X. The one key employee covered by Plan Y is the son of one of the business owners (that is, he is a key employee under the 5 percent owner test due to attribution

[26] IRC §416(c)(2)(B).

[27] Treas. Reg. §1.416-1, Q&A M-7.

[28] IRC §414(v)(3)(B), Treas. Reg. §1.414(v)-1(d)(3)(i).

of ownership from his father).

For the current plan year, the top-heavy ratio for the required aggregation group (which includes both Plans X and Y because each covers at least one key employee) is over 60 percent, so the plans are top-heavy. The key employee covered by Plan Y receives an allocation rate of only 2 percent of compensation. However, at least one key employee in Plan X receives an allocation of 3 percent of compensation. The top-heavy minimum in both plans is 3 percent for the current plan year. Plan Y may not rely on the exception discussed above (that is, the fact that the key employee in its plan received an allocation of only 2 percent of compensation), because the highest key employee allocation is based on all key employees who are in any plans in the required aggregation group.

EXAMPLE 5-28. Required Aggregation Groups. Suppose in EXAMPLE 5-27, that Plan Y covers only non-key employees. However, Plan X is unable to satisfy coverage requirements under IRC §410(b) unless it is aggregated with Plan Y. Because the plans are aggregated for coverage purposes, Plan Y is part of the required aggregation group with Plan X for top-heavy purposes, even though it covers no key employees. As in **EXAMPLE 5-27**, the top-heavy ratio exceeds 60 percent, so the group is top-heavy.

Even though there are no key employees in Plan Y and the highest key employee allocation in that plan is technically 0 percent, there is still a top-heavy minimum allocation requirement unless no key employee in Plan X receives an allocation of contributions and/or forfeitures in that plan. The top-heavy minimum allocation for Plan Y is the lesser of 3 percent of compensation or the highest allocation rate of any key employee in Plan X.

If Plan Y was not needed by Plan X to satisfy coverage rules, it would not be part of the required aggregation group with Plan X. Therefore, it would not need to be aggregated with Plan X for top-heavy purposes. Because it covers no key employees, if no aggregation is needed, no Plan Y participants will be entitled to a top-heavy minimum allocation.

It is also possible for Plan Y to be permissively aggregated with Plan X, if the two plans can satisfy coverage testing under IRC §410(b) and nondiscrimination testing under IRC §401(a)(4) on an aggregate basis. If Plan Y is permissively aggregated with Plan X and the result is that the group is not top-heavy, no minimum allocation is required for any non-key employee in either plan (even if Plan X would be top-heavy if tested alone).

Remember that employers who are related under the controlled group rules of IRC §§414(b) or (c) or under the affiliated service group rules of IRC §414(m) are treated as a single employer in applying the top-heavy rules. Therefore, if the required aggregation group consists of defined contribution plans maintained by different members of a controlled group, those plans are still treated as a single plan in determining the highest allocation rate of any key employee.

EXAMPLE 5-29. Top-Heavy Minimum in Required Aggregation Groups. Suppose that in **EXAMPLE 5-27**, Plan X covered all employees of Corporation X and Plan Y covered all employees of Corporation Y. Corporations X and Y constitute a controlled group. Plans X and Y are a required aggregation group. If the plans are top-heavy for the current year, the highest allocation rate for a key employee is determined by looking at both Plan X and Plan Y, and that rate then applies for both plans. If at least one key employee in either plan receives an allocation of 3 percent or more, all non-key employees in both plans must receive a 3 percent allocation.

If instead, the highest allocation rate for any key employee in either plan was only 2 percent, the exception to the 3 percent allocation rule would apply and all non-key employees in both plans must receive a 2 percent allocation.

If You're Curious . . .

If a defined contribution plan is included in the required aggregation group with a defined benefit plan, because it enables the defined benefit plan to satisfy coverage or nondiscrimination testing, the exception to the 3 percent minimum allocation does not apply. The top-heavy minimum is 3 percent of IRC §415 compensation for all plan participants in the required aggregation group who are in the defined contribution plan only. If there are participants who are in both the defined benefit plan and the defined contribution plan, special rules apply that will be discussed later in this chapter.

EXAMPLE 5-30. Defined Benefit and Defined Contribution Plan Contributions. Company A maintains a defined benefit plan and a defined contribution plan. All defined contribution plan participants are non-key employees. However, the defined benefit plan is unable to pass coverage testing unless it is aggregated with the defined contribution plan. Therefore, the defined contribution plan is part of the required aggregation group with the defined benefit plan. The plans are top-heavy for the plan year. The top-heavy minimum allocation for the participants covered by the defined contribution plan is 3 percent of IRC §415 compensation, even though no key employees participate in that plan.

If two or more defined contribution plans are aggregated for top-heavy testing, but they have different plan years, the allocation rates of key employees are determined for the plan years with respect to which the determination dates fall within the same calendar year.[29]

EXAMPLE 5-31. Different Plan Years. Plans A and B are maintained by related employers. Plan A has a July 1 through June 30 plan year. Plan B has an October 1 through September 30 plan year. To determine if the plans are top-heavy for the years beginning on July 1, 2017, and October 1, 2017, respectively, the determination dates are June 30, 2017, and September 30, 2017. Based on the aggregated account balances as of those two dates, the required aggregation group is top-heavy.

Although the top-heavy ratio is determined based on the determination date, which is the last day of the prior plan year, the key employee allocation rate is based on the current year. For Plan A, the highest key employee allocation rate for the year July 1, 2017, through June 30, 2018, is 8 percent. For Plan B, the highest key employee allocation rate for the year October 1, 2017, through September 30, 2018, is 1.5 percent. Because the plans are aggregated, all non-key employees in both Plan A and Plan B must receive allocations of at least 3 percent of compensation.

Who Gets the Top-Heavy Minimum?

Only a non-key employee who is a participant in the plan for the plan year is entitled to the top-heavy minimum allocation. A non-key employee is a participant if the employee has met the plan's eligibility requirements and the applicable entry date for participation during the plan year for which the top-heavy minimum allocation is being made or during a prior plan year.[30]

EXAMPLE 5-32. Newly Entering Non-Key Employee. A profit sharing plan requires completion of a year of service and attainment of age 21 to be eligible to enter the plan. Entry dates are the January 1 and July 1 coincident with or following completion of the eligibility requirements. The plan year ends December 31. The plan is top-heavy. Allison, a non-key employee, commences employment

[29] Treas. Reg. §1.416-1, Q&A T-24.
[30] Treas. Reg. §1.416-1, Q&A M-10.

on May 5, 2017. She is credited with a year of service on May 4, 2018, and enters the plan on July 1, 2018. Because Allison entered the plan during the 2018 year, she is eligible for the top-heavy minimum allocation for the 2017 plan year.

If, instead, Allison's date of hire was August 5, 2017, she would complete her year of service on August 4, 2018. However, Allison would not enter the plan until January 1, 2019. Because Allison does not enter the plan until 2019, she is not eligible for a top-heavy minimum contribution for the 2018 plan year.

If a plan excludes some employees from participation due to job classification, employees who satisfy the eligibility requirements but are excluded because of that classification are not eligible to receive top-heavy minimum allocations. This rule assumes that the employee is excluded for the entire plan year, and that the plan will satisfy coverage requirements with this classification exclusion. If an employee is required to be added back into the plan to satisfy coverage requirements for that year, that employee is entitled to a top-heavy minimum allocation.

A defined contribution plan may provide that, unless a non-key employee is still employed by the employer as of the last day of the plan year, he or she is not eligible to receive a top-heavy minimum allocation for that plan year.[31] This rule is not mandatory. A plan may be written to provide a minimum allocation to a non-key employee whose employment terminates before year end.

If a non-key employee is employed at year end, the plan may not require that he or she complete a certain number of hours to be eligible to receive the top-heavy minimum allocation for that plan year. This is true even if the plan otherwise imposes an hours of service condition for accrual purposes.[32] This rule must be distinguished from the hours of service requirement that must be met for initial eligibility purposes. If an employee is not eligible to participate and does not actually enter the plan, that employee is not entitled to a top-heavy minimum allocation. However, once the employee enters the plan, he or she may not be denied the minimum allocation based on a failure to complete a certain number of hours of service.

EXAMPLE 5-33. Less Than 1,000 Hours of Service. A profit sharing plan is top-heavy for a plan year. Marvin is a non-key employee participating in the plan. The plan requires 1,000 hours of service and employment on the last day of the plan year to receive a profit sharing contribution allocation. Marvin is employed on the last day of the plan year, but due to a change in work schedule, completes only 800 hours of service for the plan year. Marvin must receive a top-heavy minimum allocation for the plan year. However, he may be denied any allocation in excess of the top-heavy minimum because he has not completed the 1,000-hours-of-service requirement for the profit sharing contribution allocation.

EXAMPLE 5-34. Break in Service. Helga is a non-key employee. She originally became a participant in her employer's top-heavy profit sharing plan in 1996 after completing the plan's eligibility requirements. The plan year ends on December 31. Because of a change in work schedule, Helga completes only 450 hours of service for the plan year ending December 31, 2017, incurring a break in service for eligibility purposes. The plan imposes the break-in-service rule under IRC §410(a)(5)(C). Therefore, Helga is not a participant as of January 1, 2018, and she must complete another year of service to re-enter the plan. If Helga does not complete a year of service for 2018 (that is, she works less than 1,000 hours of service during that plan year), she is not considered a participant for the 2018 plan year and would not be entitled to the top-heavy minimum allocation. (Note that Helga is entitled to a top-heavy minimum allocation for 2017, even though she incurs a break in service as of the end of that year, because the break in service does not make her ineligible for the plan until the next plan year. Because Helga is employed on December 31, 2017, she is entitled to the top-heavy minimum

[31] Treas. Reg. §1.416-1, Q&A M-10.
[32] Treas. Reg. §1.416-1, Q&A M-10.

allocation for that plan year.)

If Helga then completes at least 1,000 hours of service in the 2019 plan year, her active participant status would be restored retroactively to January 1, 2019. She would be entitled to a top-heavy minimum for the 2019 plan year assuming that the plan's top-heavy status remains unchanged.

An employee is considered a participant in a 401(k) plan after satisfying the requirements to be eligible to make an elective contribution under the 401(k) arrangement, regardless of whether the employee actually elects to do so. This is true even if the employee is not a participant for other portions of the plan (for example, if the profit sharing or matching contribution portion of the plan has eligibility requirements that are different from those for the elective deferral arrangement, and the employee has not satisfied those conditions). Accordingly, the employee is entitled to the top-heavy minimum allocation unless one of the exceptions discussed above applies.

EXAMPLE 5-35. Participant in 401(k) Plan. A 401(k) plan's eligibility requirements are six months of service and attainment of age 21. Entry dates are the first day of each calendar quarter and the plan year ends on December 31. Charles, a non-key employee, completes the eligibility requirements on March 10, 2018, and his entry date is April 1, 2018. Charles is considered a participant on April 1, 2018, regardless of whether Charles elects to make elective contributions to the plan. If the plan is top-heavy for 2018, he is entitled to a top-heavy minimum allocation based on his IRC §415 compensation earned during all of 2016.

EXAMPLE 5-36. Immediate 401(k) Eligibility But One Year of Service for Profit Sharing and Matching Contributions. Suppose in **EXAMPLE 5-35**, the plan requires completion of one year of service to be eligible to receive a matching contribution and profit sharing contribution allocation. A year of service is defined to be a 12-month computation period in which the participant completes 1,000 hours of service.

Charles does not qualify to participate for matching contributions and profit sharing contributions until January 1, 2019. He also does not elect to make elective contributions to the plan for 2018.

Although Charles is not eligible to receive allocations of the matching contribution or profit sharing contribution in 2018 and he does not elect to participate in the 401(k) arrangement in 2018, he is nonetheless treated as a participant for that year because he is eligible to defer under the 401(k) arrangement for that year. Therefore, he is entitled to a top-heavy minimum contribution for that year.

If You're Curious . . .

If an employee is excluded from participating in the matching contribution or profit sharing contribution portions of a 401(k) plan because he or she is a member of a certain job classification, he or she would be able to participate in the elective deferral portion of the plan only. This structure is not uncommon in law firm plans, under which associate attorneys may elect to have salary deferred into the plan, but are not eligible to receive any employer contributions. Nonetheless, a non-key employee in this circumstance is still considered a participant for top-heavy purposes, and must receive the top-heavy minimum allocation, because he or she is eligible to defer under the 401(k) arrangement for the year.

The IRC permits the disaggregation of otherwise excludable employees for coverage purposes. An otherwise excludable employee is someone who is eligible for the plan, but would be excluded if the plan imposed the maximum statutory requirements of one year of service and attainment of age 21.[33] Similar disaggregation rules are permitted under the nondiscrimination testing rules of IRC §§401(a)(4), 401(k) and 401(m). This disaggregation does not apply, however, for top-heavy purposes. There-

[33] IRC §410(b)(4).

fore, otherwise excludable employees are entitled to top-heavy minimum allocations. If, however, the otherwise excludable employees are covered under a separate plan that separately satisfies coverage and nondiscrimination requirements (and the main plan also satisfies such requirements separately), the plans are not required to be aggregated and no top-heavy minimums would need to be provided to the otherwise excludable employees.

EXAMPLE 5-37. Otherwise Excludable Employees. Company A maintains a 401(k) plan for its employees. Employees are permitted to participate in the plan when they have completed three months of service. Company A elects to disaggregate otherwise excludable employees for purposes of coverage and nondiscrimination testing. As a result, participants who complete less than one year of service and are younger than age 21 are tested separately for coverage and for ADP and ACP testing. Even though these participants are disaggregated for testing purposes, they are still eligible to receive a minimum contribution if the plan is top-heavy.

EXAMPLE 5-38. Separate Plan for Otherwise Excludable Employees. Company B maintains two 401(k) plans. Plan N is for individuals who are non-key employees and who have completed less than one year of service for the company. Employees are permitted to enter Plan N upon hire. Plan O is for individuals who are key employees or who have completed one year or more of service. When an employee completes one year of service, he or she ceases to participate in Plan N and begins to participate in Plan O. Plan N is tested separately from Plan O for both coverage and nondiscrimination rules.

Because Plan N has no key employees, it is not part of a required aggregation group with Plan O. Therefore, it is not top-heavy and is not required to provide top-heavy minimum contributions to its participants, unless the plans are unable to satisfy coverage and nondiscrimination requirements when tested separately.

Some plans permit employees who have not met the plan's eligibility requirements to make rollover contributions to the plan. Such employees are called limited participants and are not considered for top-heavy purposes.[34] Nonetheless, a plan may be more liberal and entitle these limited participants to top-heavy minimums under the plan terms.

Satisfying the Top-Heavy Minimum

The top-heavy minimum must be satisfied with employer contributions and/or forfeitures. Employer contributions include profit sharing and pension contributions, as well as matching contributions under a 401(k) arrangement, but do not include the participants' elective deferrals.[35] (Remember, however, that a key employee's elective deferrals do count for purposes of determining the level of employer contribution he or she received and the amount of top-heavy minimum that must be provided to the non-key employees.) Furthermore, qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) used to help the employer pass the nondiscrimination testing for elective deferrals and matching contributions also count for satisfying the top-heavy minimum. Investment earnings allocated to the participants' accounts for the plan year are not counted to determine whether the employer has satisfied its obligation to provide a top-heavy minimum allocation.

After the employer's contribution and the forfeitures for the plan year are allocated, the administrator must determine whether any non-key employee has failed to receive the minimum allocation to which he or she is entitled under the top-heavy rules.

[34] Rev. Rul. 96-48, 1996-2 C.B. 31.
[35] Treas. Reg. §1.416-1, Q&A M-20.

EXAMPLE 5-39. Defferal Only 401(k) Plan. A top-heavy 401(k) plan provides for no matching contributions. Although the employer can make a discretionary nonelective contribution under the profit sharing portion of the plan, none is made for the current plan year. The only contributions made for the year are the elective deferrals under the 401(k) arrangement. The participants are three key employees and two non-key employees. Only one key employee elects to make deferrals for the plan year. The elective deferrals equal 5 percent of the key employee's compensation.

Dan and Donna are the two non-key employees. Dan made an elective deferral of 4 percent of compensation, and Donna contributed nothing. Both Dan and Donna are entitled to 3 percent top-heavy minimum allocations for the plan year, and the employer must make a contribution sufficient to provide those allocations. Dan's own elective deferrals do not count toward providing his top-heavy minimum, even though the top-heavy requirement arose because of elective deferrals by the key employee.

EXAMPLE 5-40. Plan with Matching Contributions. A 401(k) plan provides a matching contribution equal to 50 percent of the first 6 percent of compensation that is deferred. Thus, the maximum match is 3 percent of compensation. There are no other employer contributions to the plan. The plan is top-heavy.

There are three non-key employees who are eligible for the plan: Noelle, Bailey and Raquel. Their deferrals and matches are shown below:

Employee	IRC §415 Compensation	3% of IRC §415 Compensation	401(k) Elective Deferrals	Matching Contributions
Noelle	$50,000	$1,500	$5,000 (10%)	$1,500 (3%)
Bailey	$35,000	$1,050	$1,400 (4%)	$700 (2%)
Raquel	$25,000	$750	$0 (0%)	$0 (0%)

In Noelle's case, the matching contribution has completely satisfied the top-heavy minimum requirement, so no additional contribution is necessary. (Note that Noelle's match is not 50 percent of her deferral, because she deferred more than the 6 percent of compensation that is subject to matching.) In Bailey's case, his matching contribution is not sufficient to cover the top-heavy minimum, so he is entitled to a $350 additional employer contribution ($700 match plus $350 additional contribution equals the required 3 percent minimum of $1,050). Finally, Raquel is eligible for the 401(k) arrangement, so she is also eligible for the top-heavy minimum. In her case, the employer will have to contribute 3 percent of compensation because there were no matching contributions made on her behalf. Although the matching contributions made for Noelle and Bailey are used to satisfy the top-heavy minimum, those matching contributions are still taken into account for ACP testing purposes.

If You're Curious . . .

As is illustrated above, the use of matching contributions to satisfy the top-heavy minimums might discourage some non-key employees from making elective deferrals which, in turn, could have a negative impact on the plan's ability to pass the ADP testing under IRC §401(k), as well as the ACP testing with respect to the matching contributions under IRC §401(m).

As noted earlier, like matching contributions, QNECs and QMACs also may do double duty by helping the employer satisfy the ADP and ACP nondiscrimination testing, as well as counting towards satisfying the top-heavy minimum requirement.

EXAMPLE 5-41. QNECs. An employer contributes a 1 percent of compensation QNEC to all nonhighly compensated employees who are eligible under a 401(k) arrangement. These QNECs are included in the ADP test to boost the average deferral percentage of the NHCEs. For a non-key employee who has received the QNEC allocation, the employer contributes only an additional 2 percent of compensation to satisfy its top-heavy minimum contribution.

Satisfying the Top-Heavy Minimum in a Safe Harbor 401(k) Plan

If a top-heavy plan includes a safe harbor 401(k) arrangement, as described in IRC §401(k)(12), the safe harbor nonelective contributions or safe harbor matching contributions are permitted to be taken into account to determine if the top-heavy minimum contribution has been satisfied. Because the safe harbor nonelective contribution is equal to 3 percent of compensation, any participant receiving the nonelective contribution will be considered to have received at least part of the required top-heavy minimum contribution. Remember that the safe harbor nonelective contribution may be based on compensation for only a portion of the plan year, whereas the top-heavy minimum contribution is always calculated on the participant's IRC §415 compensation for the entire plan year.[36]

The safe harbor matching contribution may also be used to satisfy the top-heavy requirements, but, again, it may not be sufficient to fully provide the minimum contribution to all participants. Some participants will not defer salary at all (and therefore receive no match), while others may not defer sufficiently to receive a contribution of at least 3 percent of their full year IRC §415 compensation. If the match is not sufficient, the employer will need to make additional contributions, unless there are other allocations made for such participants that are sufficient to fulfill the top-heavy minimum obligation, or if the exception discussed below applies.

Deemed non-top-heavy safe harbor plans. Certain safe harbor 401(k) plans are deemed to be non-top-heavy plans under IRC §416(g)(4)(H). These top-heavy exemptions are discussed in detail in *The ASPPA Defined Contribution Plan Series Volume 2: 401(k) Plans and Intermediate Administrative Topics*, which is available at the ASPPA bookstore (ecommerce.asppa-net.org).

SUMMARY OF BASIC TOP-HEAVY PLAN REQUIREMENTS

Summary of Top-Heavy Minimum Allocation Requirements

Question	Answer
What is the top-heavy minimum allocation?	3 percent of IRC §415 compensation for the entire plan year
Are there any exceptions to the 3 percent minimum?	Yes. If all key employees' allocation rates for the plan year are less than 3 percent, the minimum is the highest allocation rate for any key employee
Who must receive the top-heavy minimum?	Non-key employees
Is employment on the last day of the plan year required to receive the allocation?	Yes. Although, if desired, a plan document may offer the top-heavy minimum without the last day allocation requirement.
Is a minimum number of service hours required to receive the allocation?	No

[36] Treas. Reg. §1.416-1, Q&A M-7.

Summary of Contributions Available to Satisfy Top-Heavy Minimum Allocation Requirements

Source	Can Count Toward Top-heavy Minimum?
Employer pension contributions	Yes
Employer nonelective contributions	Yes
Matching contributions	Yes
Forfeitures	Yes
Elective deferrals	No
QNECs	Yes
QMACs	Yes
Safe harbor nonelective contributions	Yes
Safe harbor matching contributions	Yes

PARTICIPATION IN MORE THAN ONE TOP-HEAVY PLAN

If the employer maintains more than one top-heavy plan, a non-key employee participating in both plans is not required to receive a top-heavy minimum in each plan.[37]

Participation in Two or More Defined Contribution Plans

If there are two or more defined contribution plans covering the same non-key employee, the combined allocation from the plans must equal at least the top-heavy minimum required allocation.[38] If the participant's combined allocation falls short, the plan documents will generally provide which plan will guarantee the top-heavy minimum shortfall.

In some cases, an employer will have two or more top-heavy defined contribution plans that have different participants. In that case, any non-key employee who is a participant in only one plan must be guaranteed the top-heavy minimum allocation in that plan. Any non-key employee who is a participant in two or more of the plans must be guaranteed the top-heavy minimum allocation with respect to his or her combined allocation as described above and, if there is a shortfall, one of the plans should be designated as the plan that will make up the difference.

EXAMPLE 5-42. Participation in Two Top-Heavy Plans. An employer maintains an ESOP and a separate 401(k) plan. The eligibility requirements under both plans are one year of service and attainment of age 21. Each plan covers at least one key employee, so the two plans are part of a required aggregation group. The group's top-heavy ratio exceeds 60 percent, so the plans are top-heavy. The ESOP provides that the top-heavy minimum is guaranteed in that plan, so that, if a non-key employee's total allocation of employer contributions (other than elective deferrals) and forfeitures under both plans is less than the top-heavy minimum allocation, the employer will make up the difference in the ESOP. The 401(k) plan satisfies the top-heavy minimum allocation requirement, because all non-key employees who are participants in the 401(k) plan are also participants in the ESOP and the top-heavy minimum allocation is guaranteed in the ESOP.

EXAMPLE 5-43. Two Top-heavy Plans With Different Participant Groups. Suppose in **EXAMPLE 5-42**, the 401(k) plan has a three-month eligibility service requirement, so that there are some non-key employees who are eligible for the 401(k) plan but are not eligible for the ESOP. In that case, the 401(k)

[37] IRC §416(f).

[38] Treas. Reg. §1.416-1, Q&A M-8.

plan must provide that, with respect to a non-key employee who participates only in the 401(k) plan, the top-heavy minimum allocation is provided in that plan. Alternatively, the 401(k) plan could guarantee the top-heavy minimum allocation for all non-key employees, because any non-key employee who is eligible for the ESOP is also eligible for the 401(k) plan, and the ESOP could provide that it does not guarantee the top-heavy minimum allocation. In the alternative approach, the employer will make up the difference in the 401(k) plan if a non-key employee's total allocation of employer contributions (other than elective deferrals) and forfeitures under both plans is less than the top-heavy minimum.

As mentioned above, some safe harbor 401(k) plans are deemed to be non top-heavy. If a non-key employee is a participant in a safe harbor 401(k) plan that satisfies the top-heavy exemption, but is also a participant in a separate top-heavy defined contribution plan that is part of the required aggregation group with the safe harbor plan, the safe harbor contributions are counted for purposes of determining whether the top-heavy minimum allocation has been satisfied.[39]

If You're Curious . . .

Participation in a Defined Contribution Plan and a Defined Benefit Plan

If a company maintains both a defined contribution plan and a defined benefit plan, participants covered in only one of the plans should receive the normal top-heavy minimum in the plan in which they participate. However, if an employer sponsors both a defined contribution plan and a defined benefit plan and the two plans have common participants, the regulations provide four safe harbor methods for satisfying the top-heavy minimum requirements for those participants without duplicating minimums.[40] By identifying these methods as safe harbors, the IRS is deeming the methods to satisfy the top-heavy minimum benefit requirement for all participants whose top-heavy minimum benefits are being determined under such method. These methods need apply only to a non-key employee who is covered by both plans. If a non-key employee is covered under only one of the plans, he or she must receive the top-heavy minimum in that plan, and these safe harbors do not apply.

Option 1: Provide the Defined Benefit Plan Minimum Only

If a non-key employee is eligible for a defined benefit plan and a defined contribution plan maintained by the same employer, and both plans are part of the top-heavy required aggregation group, the defined benefit plan could provide that all non-key employees who are eligible for both plans accrue only the top-heavy minimum benefit under the defined benefit plan, and are not guaranteed a top-heavy minimum allocation under the defined contribution plan. This safe harbor method deems the defined benefit plan minimum to be at least equal to the defined contribution plan minimum, even if that might not be the case under an actuarial analysis for a given participant.

Option 2: Provide the Defined Contribution Plan Minimum Only, But Increase the Minimum Required Allocation to 5 Percent of Compensation

This safe harbor method is based on the assumption that, on average, the defined benefit minimum is more valuable than the defined contribution minimum, so raising the defined contribution minimum to 5 percent roughly "evens the score".

Option 3: Use a Floor Offset Approach, Where the Defined Benefit Minimum is Provided, But is Offset by the Equivalent Benefits Provided by the Defined Contribution Plan

In this option, a non-key employee who is eligible for a top-heavy minimum under both plans would

[39] IRC §416(g)(4)(H).
[40] Treas. Reg. §1.416-1, Q&A M-12

be guaranteed the top-heavy minimum defined benefit. However, the benefit derived from employer contributions (other than elective deferrals) and forfeitures under the defined contribution plan would offset the guaranteed top-heavy minimum benefit under the defined benefit plan.

EXAMPLE 5-44. Offset Approach to Top-heavy Minimum. John participates in both a defined benefit plan and a profit sharing plan of his employer. He receives an allocation in the defined contribution plan equal to 3 percent of his compensation. An actuary projects that contribution to normal retirement, and converts it to a single life annuity payable at that time. The projected benefit is equal to 1½ percent of John's compensation. An additional accrued benefit equal to ½ percent of John's compensation must be provided in the defined benefit plan so that the total of the equivalent accrual in the profit sharing plan and the accrual in the defined benefit plan is equal to at least the 2 percent top-heavy minimum defined benefit.

Option 4: Show the Combined Benefits Provided by Both Plans Are Comparable to the Defined Benefit Plan Minimum Benefit

Under this option, the employer contributions (other than elective deferrals) and forfeitures allocated to a non-key employee under the defined contribution plan, expressed as a benefit, plus the benefit accrued by such employee under the defined benefit plan, must be not less than the 2 percent minimum benefit accrual requirement in a defined benefit plan.

TERMINATED PLANS

If a plan terminates, the requirement to provide top-heavy minimums ceases.[41] A plan is terminated if a formal termination date has been established and all assets are distributed within an administratively reasonable period of time (generally not more than one year following the plan's termination date).[42]

If a defined contribution plan requires that a non-key employee be employed on the last day of the plan year to receive a top-heavy minimum allocation, a question arises as to whether the top-heavy minimum obligation is eliminated for the plan year in which the plan terminates if the termination is effective prior to the last day of the plan year. The IRS has not addressed this issue directly, but it is unlikely that it would consider that no top-heavy minimum was required in the year of termination if any key employee received an allocation in that year. Of course, if there are no contributions or forfeitures allocated for that year, then the required top-heavy minimum would be zero.

It appears, however, that the 3 percent top-heavy minimum could be based on compensation earned through the plan's termination date.[43]

Because a defined benefit plan is not permitted to require last-day employment as a condition of accruing the minimum benefit, termination of the plan before the last day of the plan year could not alone eliminate the top-heavy minimum accrual for that year. However, the defined benefit plan may require completion of at least 1,000 hours of service to accrue the top-heavy minimum benefit for the plan year. Therefore, if the termination of the plan is effective before a non-key employee has earned at least 1,000 hours of service for the plan year, the non-key employee would not accrue a top-heavy minimum benefit for that year. Also, if the termination date is early enough that no key employee accrues a benefit, the year of termination would not be taken into account to compute the top-heavy minimum benefit if the plan year in which the plan terminates begins after December 31, 2001.

[41] Treas. Reg. §1.416-1, Q&A T-4.
[42] Rev. Rul. 89-87, 1989-2 C.B. 81.
[43] See IRS Q&A Session Q&A-1, 2003 ASPPA Annual Conference in Washington, D.C.

UNION EMPLOYEES

The top-heavy minimum benefit requirements do not apply to union employees. For this exception to apply, the employee must be included in a collective bargaining unit that is covered by an agreement where there is evidence that retirement benefits were the subject of good faith bargaining between the employee representatives and the employer or employers who are parties to the agreement. This exception applies even if the union employees are part of a top-heavy plan that also covers nonunion employees.

Section 5.09: Review of Key Concepts

- Determine whether an individual is a key employee, a non-key employee or a former key employee.
- What is a top-heavy plan?
- List the steps necessary to determine if a plan is top-heavy.
- Define the determination date.
- Which distributions are and are not included in top-heavy testing?
- Describe the plan aggregation rules as they pertain to top-heavy testing.
- What are the vesting and allocation requirements of a top-heavy plan?
- What contributions are used to determine the key employees' highest contribution rate?
- What types of contributions satisfy the top-heavy minimum requirements?
- Calculate a participant's minimum top-heavy contribution.
- Identify types of plans that may be exempt from top-heavy testing.

Section 5.10: For Practice – True or False

1. An officer earning more than $180,000 in 2018 may be considered a key employee.
2. Related rollovers between plans maintained by the same employer are included only in the recipient plan for top-heavy determination.
3. Catch-up contributions are included when determining a key employee's allocation rate.
4. In order for two plans to be part of a permissive aggregation group, they must be able to satisfy coverage and nondiscrimination requirements when considered together.
5. An employee with annual compensation in excess of $80,000 (as indexed) is a key employee in 2018.
6. Employer matching contributions may be used to satisfy top-heavy minimum requirements.
7. In a new plan, the determination date is the last day of the first plan year.
8. Only a non-key employee who is a participant in the plan for the plan year is entitled to the top-heavy minimum allocation.
9. Two plans that are not part of a required aggregation group may be permissively aggregated for top-heavy purposes.
10. A SEP plan is not subject to the top-heavy aggregation rules.

Section 5.11: Sample Test Questions

1. All of the following statements regarding top-heavy requirements are TRUE, EXCEPT:
   A. Distributions due to death made in the five-year period ending on the determination date are included in the top-heavy ratio.

B. Some safe harbor 401(k) plans are deemed not top-heavy.
C. Top-heavy defined contribution plans have minimum allocation requirements.
D. Rollovers between plans of unrelated employers are included only in the distributing plan's top-heavy testing.
E. Top-heavy plans have minimum vesting requirements.

2. Based on the following information, determine the minimum top-heavy allocation to Participant A:
    - Participant A is a non-key employee.
    - Participant A's IRC §415 compensation for the plan year is $40,000.
    - Participant A's plan compensation for the plan year is $20,000 since he entered the plan mid-year.
    - The highest allocation rate for a key employee for the plan year is 4%.
    - The plan is top-heavy for the current plan year.

   A. $0
   B. $600
   C. $800
   D. $1,200
   E. $1,600

3. Based on the following information, determine the top-heavy ratio for 2018:

Participant	12/31/2016 Balance	12/31/2017 Balance	Date of Termination	Distribution Amount	Date of Distribution
A - Non-key	$44,000	$47,000			
B - Non-key	$62,000	$68,000			
C - Non-key	$30,000	$35,000			
D - Key	$80,000	$90,000			
E - Non-key	$10,000	$12,000			
F - Key	$25,000	$16,000		$10,000	07/31/2017
G - Non-key	$7,500	$0	06/15/2015	$8,000	11/20/2017
H - Non-key	$900	$0	09/12/2017	$1,000	11/20/2017

   A. 39.55%
   B. 40.56%
   C. 41.58%
   D. 41.73%
   E. 43.38%

4. All of the following statements regarding top-heavy requirements are TRUE, EXCEPT:
   A. A plan is top-heavy if more than 60 percent of the benefits are attributable to key employees.
   B. After-tax employee contributions are included in calculating the top-heavy ratio.
   C. A top-heavy minimum contribution is required for all plan participants.
   D. Catch-up contributions made in the year in which the determination date falls are included in calculating the top-heavy ratio.
   E. In-service withdrawals made during the five-year period ending on the determination date are included in calculating the top-heavy ratio.

6. Which of the following statements top-heavy plans is/are TRUE?
   - I. A plan termination distribution from a plan in a required aggregation group is included in the top-heavy determination.
   - II. Forfeitures are considered employer contributions for determining top-heavy minimum allocation requirements.
   - III. Plans are permissively aggregated only when to do so will cause the group not to be top-heavy.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

7. Based on the following information, determine which of the employees is/are key employees as of December 31, 2018:
   - The company employs 38 people.
   - This is the first year of the company's operation.
   - None of the employees are related.

Employee	Ownership	Officer	Compensation
A	10%	Yes	$210,000
B	8%	Yes	$180,000
C	4%	Yes	$100,000
D	2%	Yes	$100,000
E	0%	Yes	$96,000

   A. Employee A only
   B. Employees A and B only
   C. Employees A, B and C only
   D. Employees A, B, C and D only
   E. Employees A, B, C, D and E

8. All of the following statements regarding top-heavy aggregation are TRUE, EXCEPT:
   A. A required aggregation group includes each plan of an employer in which a key employee participates.
   B. If the required aggregation group is top-heavy, each plan in the group is top-heavy unless the safe harbor exception applies.
   C. If a permissive aggregation group is not top-heavy, then all plans in the group are not top-heavy.
   D. A SIMPLE 401(k) plan is subject to the top-heavy aggregation rules.
   E. A required aggregation group includes each plan of an employer that enables a plan within which a key employee participates to satisfy coverage or nondiscrimination requirements.

9. Based on the following information, determine the minimum top-heavy allocation to Participant X:
   - Participant X is a non-key employee.
   - Participant X's IRC §415 compensation for the plan year is $30,000.
   - Participant X's plan compensation for the plan year is $12,000 since he entered the plan mid-year.

- Participant X worked 850 hours during the plan year.
- The highest allocation rate for a key employee for the plan year is 2%.
- The plan is top-heavy for the current plan year.

A. $0
B. $240
C. $300
D. $360
E. $600

10. Based on the following information, determine the top-heavy ratio as of December 31, 2018:

Participant	Key	12/31/18 Account Balance	Termination Date	Distribution	Year Paid
A	Yes	$300,000			
B	Former	$200,000			
C	No	$50,000			
D	No	$0	2/15/18	$25,000	2018

A. $300,000 / $375,000
B. $300,000 / $550,000
C. $300,000 / $575,000
D. $500,000 / $550,000
E. $500,000 / $575,000

See next page for answers to the true/false and sample test questions.

Section 5.12: Solutions to True or False Questions

1. True.
2. True.
3. False. Catch-up contributions are disregarded when determining a key employee's allocation rate.
4. True.
5. False. The employee's compensation level alone will not make the employee a key employee. Do not confuse HCE determination with key employee determination.
6. True.
7. True.
8. True.
9. True.
10. False. A SEP plan is subject to the top-heavy aggregation rules.

Section 5.13: Solutions to Sample Test Questions

1. The answer is **A**. Only certain in-service withdrawals made in the five-year period are included in the top-heavy ratio. A distribution due to death would only be included if made in the one-year period ending on the determination date and the deceased participant had at least one hour of service in that same period.
2. The answer is **D**. The top-heavy minimum contribution is the lesser of 3 percent of compensation or the highest allocation rate for any key employee. Since the highest allocation rate for a key employee was 4 percent, the top-heavy minimum contribution is 3 percent of compensation. Compensation for purposes of determining top-heavy minimum allocations is IRC §415 compensation, which is $40,000 for Participant A. 3 percent of $40,000 is $1,200.
3. The answer is **C**. The determination date is 12/31/2017. The top-heavy ratio is determined by taking account balances as of 12/31/2017 and adjusting them for 1) distributions to terminated participants made during the one-year period ending on the determination date for participants with one hour of service in that period (Participant H), and 2) certain in-service withdrawals made during the five-year period ending on the determination date (Participant F). The top-heavy ratio is the key employees' includible account balances and distributions ($90,000 + $16,000 + $10,000 = $116,000) divided by the includible account balances and distributions for both key and non-key employees ($47,000 + $68,000 + $35,000 + $90,000 + $12,000 + $16,000 + $10,000 + $1,000 = $279,000). $116,000 / $279,000 = 41.58%
4. The answer is **C**. If a top-heavy minimum contribution is required, it need only be allocated to non-key employees who are employed on the last day of the plan year, not all participants.
5. The answer is **B**. The stock ownership (2 percent) is attributed to the mother, but she does not have enough compensation to be considered a key employee.
6. The answer is **E**. All of the statements are true.
7. The answer is **B**. Key employees would be those who 1) own more than 5 percent, 2) own more than 1 percent and earn more than $150,000, or 3) are officers who earn more than $175,000. Employees A and B are both more than 5 percent owners.
8. The answer is **D**. A SIMPLE 401(k) is not subject to top-heavy aggregation rules.
9. The answer is **E**. The top-heavy minimum contribution is the lesser of 3 percent of compensation or the highest allocation rate for any key employee. Since the highest allocation rate for a key employee was 2 percent, the top-heavy minimum contribution is 2 percent of compensation. Compensation for purposes of determining top-heavy minimum allocations is IRC §415 compensation, which is $30,000 for Participant X. 2 percent of $30,000 is $600. If a non-key employee is employed at year end, the plan may not require that he or she complete a certain number of hours to be eligible to

receive the top-heavy minimum allocation for that plan year. Thus, the hours of service for Participant X are irrelevant.

10. The answer is **A**. The top-heavy ratio is determined by taking account balances and adjusting them for 1) distributions made to terminated participants during the one-year period ending on the determination date for participants with one hour of service in that period (Participant D), and 2) certain in-service withdrawals made during the five-year period ending on the determination date (none). The top-heavy ratio is the key employees' includible account balances and distributions ($300,000) divided by the includible account balances and distributions for both key and non-key employees ($300,000 + $50,000 + 25,000 = $375,000). The account balances of former key employees are disregarded.

CHAPTER 6:
REQUIREMENTS FOR COVERAGE

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Section 6.01: Key Terms

- Annual testing method
- Average benefit test
- Average benefit percentage test
- Benefiting group
- Corrective amendment
- Coverage testing group
- Daily testing method
- Dual eligibility
- Employer
- Excludable employee
- Fail-safe provision
- HCE ratio
- Leased employee
- NHCE ratio
- Nondiscriminatory classification test
- Nonexcludable employee
- Otherwise excludable employee
- Quarterly testing method
- Ratio percentage
- Ratio percentage test
- Snapshot testing method
- Statutory employee

Section 6.02: Introduction

A plan is not qualified unless it benefits a minimum number of employees. The minimum number required depends on the size of the employer, the employee demographics and sometimes the level of benefits provided under the plan. These requirements are known as coverage rules. This chapter explains the various methods of testing coverage and how violations may be corrected.

Internal Revenue Code (IRC) §410(b) is relevant to the discussions in this chapter. This IRC section outlines two coverage tests—the ratio percentage test and the average benefit test—one of which must be satisfied by the plan.

The Treasury Regulations issued under these rules are §§1.410(b)-2 through 1.410(b)-10. [Treas. Reg. §1.410(b)-1 was issued under the pre-1989 coverage rules and applies only for years subject to those requirements.]

COVERAGE TESTING AND ELIGIBILITY REQUIREMENTS

In Chapter 3, we discussed the minimum age and service requirements a plan may establish as conditions for becoming a participant. We noted that an employee may satisfy the minimum age and service requirements but still not become a participant because of an eligibility condition not related to age or service.[1] For example, a plan might exclude employees who are paid on an hourly basis, who have a certain job title or who work in a particular division. If there was no limitation on these conditions, an employer could draft a plan with so many eligibility exclusions that only a small segment of the workforce would actually benefit from the plan. The coverage requirements are imposed to establish certain limitations on these additional exclusions. If the plan cannot pass coverage because of those exclusions, the plan will have to be redesigned to expand coverage to be qualified.

A plan does not generally have to state the coverage testing method in the document. Testing is an operational requirement. The plan administrator may use any method discussed in this chapter to meet this requirement and even may try several different testing options before determining that the plan passes. Furthermore, the plan administrator could use different testing methods from year to year. However, if the methodology affects benefits or contributions, then the test must be stated in the plan. For example, some plans use a fail-safe provision (defined later) to ensure that a particular coverage method is satisfied. If this is a desired objective, the manner in which the coverage test is performed before the fail-safe provision is applicable must be stated in the plan document.

STRUCTURE OF THE CHAPTER

Coverage is a very complex concept in the IRC. Therefore, we will first discuss the general rules of coverage testing.

[1] IRC §410(a)(4).

Once the basic concepts of testing have been reviewed, we will discuss several variations on the basics that can modify the standard rules.

Section 6.03: Minimum Coverage Tests: The Basics

There are two minimum coverage tests under IRC §410(b):

1. the ratio percentage test; and
2. the average benefit test.

The plan must pass one of those two tests in every plan year. The plan need not pass the same test each year, as long as it passes at least one of the tests. Failure to satisfy coverage for a plan year results in disqualification, even if the plan has satisfied the minimum coverage tests in all prior years.

To determine whether the plan passes the ratio percentage test or the average benefit test, the coverage testing group and the benefiting group must be identified. A determination also needs to be made as to which employees in each group are HCEs and which are NHCEs.

The ratio percentage test and the average benefit test are both objective, mathematical analyses of the demographics of the company. The numbers will determine if the coverage testing is satisfied or if some correction will need to be done.

The following steps must be followed to perform the testing:

1. Identify the employer for testing purposes.
2. Identify the entire workforce of the employer.
3. Determine who within the workforce may be excluded from the coverage testing (i.e., the excludable employees) and determine the remaining coverage testing group.
4. Determine who among the coverage testing group is an HCE and who is an NHCE.
5. Determine who within the coverage testing group is benefiting under the plan.
6. Perform the ratio percentage test.

If the ratio percentage test is passed, you are done. If it is failed, you must either make a correction that will enable passage of the test or use the average benefit test to pass coverage. The average benefit test is discussed here, but is covered in more detail in *The DC-3 Study Guide: Advanced Compliance and Administration Topics*, available in the ASPPA Bookstore (ecommerce.asppa-net.org).

STEP 1: IDENTIFY THE EMPLOYER

Before the workforce can be determined, the employer must be identified. Often the **employer** is a single entity, but could also be a controlled group or affiliated service group. If the plan sponsor is part of a controlled group or affiliated service group, the whole group is the employer for testing purposes, even if the plan has not been adopted by all members of the group.

STEP 2: IDENTIFY THE ENTIRE WORKFORCE

The starting point for determining the coverage testing group is the total **workforce** of the employer (i.e., the sponsor of the plan being tested), as well as all related employers under IRC §§414(b), 414(c), 414(m) and 414(o) – that is, all companies that are part of the controlled group or the affiliated service group with the plan sponsor.

The workforce does not include independent contractors.

Leased Employees

IRC §414(n)(3)(B) includes IRC §410 in the list of employee benefit requirements for which a leased employee is treat-

ed as an employee of the recipient employer. The recipient employer is the employer who receives the services of the leased employees. Therefore, the coverage testing rules are applied by the recipient by treating the leased employees as part of the recipient's workforce. This does not mean that leased employees must be included in the employer's plan, only that they are included in the coverage testing.

Factors That Determine a Leased Employee

For an individual to be treated as a leased employee under IRC §414(n), the following conditions must be met:

1. The recipient employer must be paying a fee for the services of the individual;
2. The individual must be providing services for the recipient on a substantially full-time basis for at least one year;
3. The recipient employer must have primary direction or control over the individual's services; and
4. The leasing organization (the company that is leasing the employee to the recipient), not the recipient employer, must be the common law employer of the individual.

STEP 3: DETERMINE EXCLUDABLE EMPLOYEES AND THE COVERAGE TESTING GROUP

Once the workforce has been determined, one must identify which employees within that workforce must be included in the numerical coverage testing. These employees make up the coverage testing group.

The **coverage testing group** consists of all employees in the workforce except those who are excludable employees for coverage testing purposes. The term excludable employees is defined below. It is important to remember that not all employees who the employer excludes from the plan are excludable employees for coverage testing purposes.

If everyone in the coverage testing group is benefiting under the plan (that is, part of a narrower group called the benefiting group), the plan will automatically pass coverage testing. However, depending on the terms of the plan, some of the members of the coverage testing group may not be considered to be benefiting. If that is so, the plan might not pass coverage.

Factors That Determine Excludable Employees

Excludable employees are those that are not included in the numerical coverage testing. This term is not synonymous with the individuals who are excluded from participation by the terms of the plan and also should not be confused with *otherwise excludable employees*, discussed in Chapter 5.

Excludable employees are only those who the law permits an employer to exclude without negatively affecting the testing results. An employee may be an **excludable employee** if he or she falls into any of the following categories:

- The employee does not satisfy the plan's age and service requirements to become a participant in the plan;
- The employee is a terminated participant in the plan, with 500 or fewer hours of service for that plan year and is not benefiting under the plan;
- The employee is a collectively bargained employee (i.e., a union employee whose benefits have been negotiated in a collective bargaining process) and the coverage test is being run with respect to a plan (or portion of a plan) that covers noncollectively bargained employees; or
- The employee is a nonresident alien for US tax purposes—that is, has no US source income.

The employee must be an excludable employee for the entire testing period to be excluded from the coverage test group for that period. The testing period is usually the plan year, because most plans perform coverage under the annual testing method. If the quarterly testing method or daily testing method is used, then the coverage testing group is determined separately for each testing period (quarter or day, as the case may be) and an employee is excluded from the coverage testing group only if he or she is an excludable employee for that testing period. We will talk more about alternative testing periods below.

Excludable Employee Group 1: Employees Who Do Not Satisfy the Plan's Age and Service Requirements

If the plan imposes an age or service requirement for eligibility purposes, any employee who has not satisfied those requirements is excludable for purposes of coverage testing.[2] For example, if the plan requires one year of service, any employee who has not completed the year of service requirement is excludable from the plan and is excludable for coverage testing purposes.

The reason for this rule is that IRC §410(a) outlines separate rules for when someone may be excluded due to age and service. If an employee is not covered by the plan because of those age and service requirements, the plan's coverage testing should not be negatively affected.

EXAMPLE 6-1. Ineligible Employees Excluded from Coverage Test. For the current plan year, an employer has a total workforce of 40 employees. Of those employees, ten do not satisfy the plan's minimum age and service requirements during this plan year. The ten employees are excludable employees for coverage testing purposes. The number of employees in the coverage testing group is 30.

Most plans use an entry date system to specify when an employee becomes a participant. The most common is the semiannual entry date system, where the first day of the plan year and the first day of the seventh month of the plan year are the only entry dates. If the employee becomes a participant on an entry date following completion of the age and service requirements (or would become a participant on such date but for other eligibility conditions not related to age or service), he or she is treated as an excludable employee for coverage testing purposes until that entry date.[3]

If the employee is excluded from the plan after the entry date (e.g., the employee is in a job classification that is excludable from the plan), the employee is not an excludable employee for coverage testing purposes after the entry date (unless he or she is an excludable employee because of one of the other classifications below).

EXAMPLE 6-2. Ineligible Employee for Part of the Year. Jackie is hired on June 1, 2018. The plan requires one year of service for eligibility purposes. The plan year ends December 31, and entry dates are January 1 and July 1. Jackie completes the year of service requirement on May 31, 2019, and becomes an eligible participant on July 1, 2019. The plan performs coverage testing on a plan year basis (i.e., the annual testing method). Jackie is not an excludable employee for the 2019 plan year, even though, for part of the plan year, she had not satisfied the plan's eligibility service requirement.

Suppose the plan also has an age 21 requirement for eligibility and Jackie's date of birth is March 15, 1999. In this instance, Jackie would not satisfy the plan's age requirement until March 15, 2020, and would become an eligible participant on July 1, 2020. Although Jackie satisfied the one year of service requirement in 2019, her failure to satisfy the age requirement would make her an excludable employee until the 2020 plan year.

EXAMPLE 6-3. Employee Who has Completed Eligibility Requirements But has Not Entered the Plan. A calendar year profit sharing plan has a one-year-of-service eligibility condition, with semiannual entry dates on January 1 and July 1. An employee commences employment on August 1, 2018. At the end of the initial eligibility computation period (July 31, 2019), the employee is credited with a year of service. The entry date for this employee is January 1, 2020 (the first day of the next plan year). Therefore, for the entire 2019 plan year, the employee is an excludable employee, even though the employee actually is credited with a year of service on July 31, 2019.

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[2] IRC §410(b)(4)(A) and Treas. Reg. §1.410(b)-6(b)(1).

[3] IRC §410(b)(4)(C).

EXAMPLE 6-4. Excluded by Employment Classification. A plan excludes hourly paid employees. The plan year ends December 31. The plan requires one year of service for eligibility purposes. The entry date is the January 1 or July 1 next following completion of these requirements. However, if the employee is an hourly paid employee on such entry date, entry into the plan is postponed until the employee becomes a salaried employee.

Agnes is hired on April 1, 2018. She completes at least 1,000 hours of service during her initial eligibility period (April 1, 2018, through March 31, 2019). The applicable entry date is July 1, 2019. Agnes is an hourly paid employee so she does not become a participant on July 1, 2019. For coverage purposes, Agnes is an excludable employee only until July 1, 2019. Thereafter, she is included in the coverage testing group. So, Agnes must be taken into account for coverage testing in the 2019 plan year.

It is possible that an employee may be excluded from a plan because of conditions not related to age or service.[4] An employee who is excluded from the plan because of the plan's age and service requirements is excluded from the coverage testing group. Therefore, excluding an employee solely because of the minimum age and service requirements will not affect a plan's ability to satisfy coverage. But if the employee does satisfy those requirements, yet is excluded from the plan because of another eligibility condition, he or she is not an excludable employee for coverage testing purposes unless the reason for the exclusion falls within one of the excludable employee definitions (e.g., union exclusion or nonresident alien exclusion).

EXAMPLE 6-5. Employee Falls Into Another Excludable Employee Category. Suppose in the prior **EXAMPLE 6-4** that Agnes is a union employee. Also assume that the plan being tested is for nonunion employees. Although as of July 1, 2019, Agnes is not treated as an excludable employee by reason of the plan's age and service requirements, she is still an excludable employee because of the union exclusion. Under these facts, she is not part of the coverage testing group for the 2019 plan year.

As this discussion illustrates, not all *excluded* employees are *excludable* employees. Excludable employees are only those who fit into one of the defined categories and, as a result, are not included in the coverage testing group. Other employees who are excluded from the plan, but are not excludable employees, are included in the coverage testing group. When a nonexcludable employee is excluded from the plan, there is a potential for the plan to fail coverage testing.

Rollovers before participation. Some plans permit an employee to make rollover contributions to the plan before they actually become participants. In Rev. Rul. 96-48,[5] the IRS refers to employees who are eligible to make pre-participation rollovers as limited participants. Rev. Rul. 96-48 makes clear that a limited participant is considered an excludable employee for coverage testing purposes if the employee does not satisfy the age and service requirements imposed by the plan. This is true even if the employee has elected to make a rollover contribution before he or she otherwise satisfies the age and service requirements.

Impact of break-in-service rules. Break-in-service rules may be used in a plan to disregard eligibility service earned prior to a break-in-service period. During any period that the employee's prior service is being disregarded under this rule, the employee is an excludable employee for coverage testing purposes because the employee is treated as not having satisfied the plan's eligibility service requirements.

Eligibility for the plan vs. eligibility to receive an allocation under the plan. This exclusion category pertains only to employees who have failed to satisfy the plan's eligibility requirements (i.e., the conditions for becoming a participant in the plan) or are deemed not to have satisfied those requirements because of the break-in-service rules. Many plans require an eligible participant to satisfy certain conditions on an annual basis to accrue benefits for each plan year during which the employee is eligible for the plan. For example, a defined contribution plan might require an eligible

[4] IRC §410(a)(4).
[5] 1996-2 C.B. 31.

participant to perform at least 1,000 hours of service or to be employed on the last day of the plan year to share in the allocation of employer contributions. Whether an eligible participant satisfies these conditions is irrelevant in determining whether the employee is excludable under this category for coverage testing. The employee who has satisfied the plan's eligibility age and service requirements would not be an excludable employee under this category even if he or she fails to get an allocation of employer contributions because of a failure to complete any allocation conditions for the plan year. However, the employee might be an excludable employee under the second category of excludable employee (terminated with 500 or fewer hours of service), described below.

EXAMPLE 6-6. Previously Eligible Employee Not Entitled to Allocation of Contribution During the Year. Phillip was hired in September 2015. He satisfied the plan's eligibility service requirement (i.e., one year of service) in September 2016 and became an eligible participant on January 1, 2017. The plan is a profit sharing plan and the plan year ends December 31. On May 1, 2019, Phillip is laid off. The plan requires employment on the last day of the plan year to receive an allocation of employer contributions. Phillip is not an excludable employee for the 2019 plan year under the age and service exclusion category, because he satisfied the plan's eligibility service requirement as of January 1, 2017. This is true even though he fails to satisfy the plan's conditions to receive an allocation for the 2019 plan year. However, Phillip might be an excludable employee under the terminated participant exclusion category described below, depending on how many hours of service he completed during the 2019 plan year.

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Multiple age/service eligibility requirements. If the plan provides for two or more different sets of minimum age and service eligibility requirements, the excludable employees under this category are only those who fail to satisfy all sets of age and service requirements (i.e., the lowest of those requirements).[6] This could result in a greater number of employees included in the coverage testing group than might be the case if only the more stringent requirements were in the plan.

EXAMPLE 6-7. Different Age and Service Conditions. Law Firm X sponsors a profit sharing plan. The plan permits entry by partners and staff after the completion of three months of service. However, associate attorneys are allowed to enter the plan only after the completion of one year of service in which they complete at least 1,000 hours. When determining who is an excludable employee, only those associates with fewer than three months of service will be excludable.

When an employer tests a plan for coverage, it determines excludable employees based on the age and service conditions of that plan, regardless of whether another plan maintained by the employer has different conditions. An exception to this rule applies if the plans are being permissively aggregated. Permissive aggregation is discussed in the Special Coverage Rules section below. In addition, if the average benefit percentage has to be calculated because the plan is relying on the average benefit test to pass coverage, a separate determination of excludable employees is made solely for purposes of the average benefit percentage, as if the aggregated plans included in the average benefit percentage are a single plan.

EXAMPLE 6-8. Different Eligiblity Service Conditions. An employer maintains two plans: one money purchase plan and one profit sharing plan. The money purchase plan's eligibility requirements are one year of service and age 21. The profit sharing plan's eligibility requirements are six months of service and age 21. Unless the plans are permissively aggregated, the excludable employees under each plan are determined separately, based on the characteristics of the

[6] Treas. Reg. §1.410(b)-6(b)(2).

plan being tested. When the money purchase plan is tested, only employees who satisfy the one year of service and age 21 requirements are taken into account. When the profit sharing plan is being tested, employees who satisfy the six months of service and age 21 requirements are taken into account. As a result, each plan could have a different number of excludable employees, even though the plan years of the two plans are the same.

Similarly, when two plans are being tested for coverage separately, each plan may base the testing on its plan year or other testing period. This may result in a different number of excludable employees for the two plans.

EXAMPLE 6-9. Different Plan Years. An employer maintains a money purchase plan and a profit sharing plan. Both plans have a one year of service eligibility requirement. The plan year of the money purchase plan ends June 30, which matches the company's taxable year. The plan year of the profit sharing plan ends December 31. When the money purchase plan is tested for coverage, the period July 1 through June 30 is used to determine which employees are excludable employees, but when the profit sharing plan is tested for coverage, the period January 1 through December 31 is used. As a result, the plans could have different numbers of excludable employees in their respective plan years. Furthermore, these plans may not be permissively aggregated because they do not have the same plan year.[7] If the plans also have different eligibility age and service conditions, each plan uses its own eligibility conditions to determine excludable employees for the plan year being tested for coverage.

Excludable Employee Group 2: Exclusion of Certain Terminated Participants

If a participant terminates during the plan year, he or she is still part of the workforce for that year for purposes of determining the coverage testing group. However, if the participant is credited with 500 or fewer hours of service in the year of termination, he or she may be treated as an excludable employee for coverage testing purposes if all of the following conditions are met:

1. An employee is otherwise eligible to participate in the plan;[8]
2. The plan has a minimum service requirement (e.g., 1,000 hours) and/or a last-day-of-the-plan-year employment requirement as a condition to accrue a benefit or receive a contribution allocation;[9]
3. The participant fails to accrue a benefit (or receive an allocation) for the plan year solely because of his or her failure to complete the condition(s) for accruing a benefit or the right to a contribution allocation;[10] and
4. The participant is not employed by the employer on the last day of the plan year, has been credited with 500 or fewer hours of service, and is not benefiting under the plan.[11]

Because the regulation states that the participant fails to accrue a benefit solely because of the service and/or last day condition, if an employee is ineligible for a plan because of a job category exclusion, the employee is not an excludable employee by reason of this exception. Unless the employee is an excludable employee because of the plan's minimum age and service eligible conditions or because of the union or nonresident alien exclusions, the employee would be a nonexcludable employee (i.e., part of the coverage testing group), even if he or she terminates employment during the plan year with 500 or fewer hours of service.

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[7] Treas. Reg. §1.410(b)-7(d)(5).
[8] Treas. Reg. §1.410(b)-6(f)(1)(ii).
[9] Treas. Reg. §1.410(b)-6(f)(1)(iii).
[10] Treas. Reg. §1.410(b)-6(f)(1)(iv).
[11] Treas. Reg. §1.410(b)-6(f)(1)(v).

EXAMPLE 6-10. 500 or Fewer Hours Completed. A profit sharing plan requires a participant to have at least 1,000 hours of service credited for the plan year and to be employed on the last day of the plan year (December 31) to qualify for an allocation of employer contributions. Joseph satisfied the plan's eligibility requirements in 2005 and became a participant in the plan as of January 1, 2006. On April 1, 2017, Joseph terminates employment and does not get a profit sharing allocation for the plan year ending December 31, 2017. Joseph's hours of service for the plan year total 400.

When testing coverage for the plan year, Joseph normally would be included in the coverage testing group because he is not excludable due to the age and service requirements (i.e., he already satisfied the plan's age and service requirements for eligibility purposes). However, because he terminated during the plan year and was not credited with more than 500 hours of service for the plan year, he may be treated as an excludable employee.

EXAMPLE 6-11. More Than 500 Hours Completed. Suppose in the prior **EXAMPLE 6-10** that Joseph had completed 600 (rather than 400) hours of service for the plan year by his termination date. The plan may not treat him as an excludable employee, even though Joseph does not share in the allocation of employer contributions for the plan year. That means Joseph is included in the coverage testing group, even though he may not receive any contribution allocation.

EXAMPLE 6-12. Job Exclusion. Becky is employed by a company that maintains a plan with eligibility conditions of one year of service and age 21. The plan excludes hourly-paid employees. The plan year ends December 31. Becky is hourly paid. She was hired in 2010 and has completed the one-year and age-21 conditions. The plan requires participants to complete 1,000 hours of service and to be employed at the end of the plan year as a condition for allocations of employer contributions. Becky terminates employment in February 2018, having completed only 225 hours for the plan year.

Becky is not an excludable employee for coverage testing purposes for the 2018 plan year. She is excluded from the plan because of her hourly-paid job classification, so her failure to complete the 1,000-hours and last-day conditions for accrual is not the sole reason for her failure to benefit under the plan. She also has completed the plan's eligibility age and service conditions so she is not excludable for coverage testing purposes under the first excludable employee category.

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An employer may choose not to use this exclusion of certain terminated participants rule for determining the coverage testing group.[12] Whatever the employer decides must be consistently applied. In other words, all terminated employees must be treated the same way in determining the coverage testing group. A plan may eliminate the chance that accrual requirements will cause a coverage problem for the plan by imposing what are called safe harbor accrual or allocation requirements. Safe harbor accrual requirements provide that a participant will accrue a benefit if he or she satisfies at least either of the following conditions:

1. He or she is employed by the employer on the last day of the plan year (without regard to hours of service completed for that plan year); or
2. He or she has completed more than 500 hours of service for the plan year.

This way, the only participants who would fail to accrue a benefit are excludable for coverage testing purposes. A standardized pre-approved plan is required to use safe harbor accrual requirements so that coverage cannot be failed by the plan.[13]

[12] Treas. Reg. §1.410(b)-6(f)(1)(vi).
[13] Rev. Proc. 2000-20, section 4.12.

A plan that uses the elapsed time method of crediting service may use either 91 calendar days or three consecutive calendar months instead of 501 hours of service to determine whether an employee is excludable under this category.[14] Thus, the terminated participant would be treated as an excludable employee for coverage testing purposes only if he or she terminates no later than the 91st day of the plan year (or by the close of the third month of the plan year), regardless of the number of hours of service he or she is credited for that plan year.

Excludable Employee Group 3: Exclusion of Union Employees to Test Nonunion Plan

When testing a nonunion plan, the collectively bargained (union) employees are excludable employees.[15] A union employee is excludable only if the employee is covered by a collective bargaining agreement in which retirement benefits were the subject of good faith bargaining.[16] This exclusion recognizes the separate protections afforded union employees through the collective bargaining process. What the union employees negotiate in the way of retirement plan benefits (including no benefits) will not impact the ability of a nonunion plan to satisfy the coverage requirements.

For a plan covering union employees, all nonunion employees are effectively treated as excludable employees. To support this conclusion, consider how the regulations apply the coverage tests to union employees. Treas. Reg. §1.410(b)-7(c)(4)(ii)(B) treats a plan that covers union and nonunion employees as if it were two plans, one covering union employees and the other covering nonunion employees. Treas. Reg. §1.410(b)-2(b)(7) deems a union plan, or the disaggregated union portion of a plan, as passing coverage. Therefore, the nonunion employees do not have to be taken into account to determine if the union plan (or disaggregated union portion of a plan) satisfies IRC §410(b).

EXAMPLE 6-13. Union Employees Excluded. A corporation's workforce for the plan year totals 140 employees. Of these employees, 100 are covered by a collective bargaining agreement. When testing coverage for the nonunion employees' profit sharing plan, the corporation excludes the 100 union employees. The maximum number in the coverage testing group will be 40 employees, but may be less if some of these 40 employees fall into other excludable employee categories for coverage testing purposes.

If You're Curious . . .

If an employee performs hours of service during the plan year as both a collectively bargained employee and as a noncollectively bargained employee, the employee has dual status for that year.[17] When testing a nonunion plan (or nonunion portion of a plan), the employee is not excludable for coverage testing purposes under this category with respect to a testing period in which he or she performs hours as a noncollectively bargained employee. If the testing period is the plan year, under the annual testing method (which is usually the case), the employee would not be an excludable employee under the union exclusion category if he or she has at least one hour of service as a noncollectively bargained employee for that plan year. However, if a snapshot testing date is used under the annual method, the employee would be an excludable employee for coverage testing purposes under the union exclusion category if, on the snapshot testing date, he or she performs no hours as a noncollectively bargained employee.

Davis-Bacon employees. The Davis-Bacon Act requires government contractors to pay employees prevailing wages and benefits. To satisfy part of the prevailing wage requirements of the Davis-Bacon Act,[18] many employers provide qualified plan benefits, usually in the form of employer contribu-

[14] Treas. Reg.§1.410(b)-6(f)(1)(v).
[15] Treas. Reg.§1.410(b)-6(d).
[16] IRC §410(b)(3)(A).
[17] Treas. Reg. §1.410(b)-6(d)(2)(i).
[18] 40 U.S.C. §§276a to 276a-5.

tions to a profit sharing plan or money purchase plan. There is no rule that permits a plan to treat Davis-Bacon employees (or the portion of an employee's hours that are covered by the Davis-Bacon Act) as excludable employees when testing a non-Davis-Bacon plan for coverage testing purposes. If a non-Davis-Bacon plan is unable to satisfy coverage and/or nondiscrimination testing on its own, the employer might use the permissive aggregation rules to aggregate the Davis-Bacon plan with the non-Davis-Bacon plan for coverage testing purposes.

Excludable Employee Group 4: Exclusion of Certain Nonresident Alien Employees

An employee who is not a US citizen, who is a nonresident alien for federal tax purposes, and who receives no US source income [as defined in IRC §§861(a)(3) and 911(d)(2)] from the employer is an excludable employee.[19] Generally, income for personal services is not US source income unless it is for services performed in the United States. Merely because a nonresident alien receives compensation from a US company does not mean the individual has US source income if the compensation is for services performed outside of the US. (For more information on how to determine whether an alien is a resident alien or a nonresident alien for tax purposes, and whether a nonresident alien receives US source income, see IRS Publication 519, U.S. Tax Guide for Aliens. Also see IRS Publication 570, Tax Guide for Individuals With Income From U.S. Possessions.)

If an employee is a nonresident alien, but receives earned income from US sources, he or she may be treated as an excludable employee for coverage testing purposes if all of the employee's US source income from the employer is exempt from tax under a tax treaty.[20] The employer must treat all employees the same way in applying this rule.

This exclusion recognizes an employer may have foreign operations or may be part of a controlled group of businesses that includes foreign companies. Without this exclusion, the plan could fail coverage merely because it does not cover the foreign employees.

Nonexcludable Employees

An employee who does not fall into any of the excludable employee categories must be treated as a **nonexcludable employee** for coverage testing purposes, regardless of whether he or she or she has waived participation in the plan, even if that waiver is irrevocable. There are no special rules in the coverage regulations that treat an employee differently solely because of a participation waiver.[21]

The Coverage Testing Group and Testing Period Options

Testing Period

The regulations outline three options for testing coverage for the plan year. The method used will affect how the coverage testing group is determined.

Annual testing. The **annual testing method** is the most popular. Under this method, anyone who is an employee at any time during the plan year is included in the workforce for purposes of identifying the coverage testing group, even if the employee terminates during the plan year.[22] The excludable employee definitions are applied to the workforce to arrive at the coverage testing group. To be an excludable employee under the annual testing method, the employee must be an excludable employee for the entire plan year.

The annual testing method must be used to test coverage for a 401(k) arrangement (elective deferrals) or a 401(m) arrangement (matching contributions or after-tax employee contributions).[23]

[19] IRC §410(b)(3)(C) and Treas. Reg. §1.410(b)-6(c).
[20] Treas. Reg. §1.410(b)-6(c)(2).
[21] See, Treas. Reg. §1.410(b)-6.
[22] Treas. Reg. §1.410(b)-8(a)(4).
[23] Treas. Reg. §1.410(b)-8(a)(1).

Coverage Testing Group

Once the excludable employees have been identified, subtract those employees from the workforce to arrive at the coverage testing group. If the plan benefits all members of the coverage testing group, the plan's coverage is 100 percent and IRC §410(b) is satisfied. If the plan benefits less than the entire coverage testing group, coverage is an issue and needs to be tested.

EXAMPLE 6-14. Coverage Testing Group. Suppose the following employee information applies for a plan year:

(a) Workforce:	35
(b) Excludable employees (as defined above)	
(i) Age/service:	12
(ii) Terminated with 500 or fewer hours:	3
(iii) Union:	0
(iv) Nonresident alien:	0
(c) Subtotal:	15
(d) Coverage testing group [(a) - (c)]:	20

The coverage testing group consists of 20 employees. The failure to benefit the 15 excludable employees will not have any impact on the plan's ability to satisfy coverage requirements. Only the benefiting status of the 20 nonexcludable employees will be taken into account to determine whether the plan satisfies the coverage requirements.

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A variation of the annual testing method is the **snapshot testing method**.[24] Under snapshot testing, a single testing date is chosen. The testing date must be reasonably representative of the workforce and plan coverage for the plan year. A snapshot testing date generally should be early in the plan year (for example, first day of the plan year), so that the workforce used does not fail to take into account employees who terminate during the plan year. This rule is intended for use primarily by larger companies for which tracking the workforce over the entire plan year may be unnecessarily burdensome.

Quarterly testing. Under the **quarterly testing method**, the employer chooses four testing dates, one in each quarter of the year, to demonstrate the plan satisfies coverage.[25] The workforce is determined separately for each testing date. The excludable employee definitions are applied to the workforce determined for each testing date to arrive at the coverage testing group for that date. The same rules apply to each quarterly testing date as explained in the prior **EXAMPLE 6-14** for a snapshot testing date. Few plans elect to use the quarterly testing method.

Daily testing. Under the **daily testing method**, the plan tests coverage every day of the plan year, treating each day as a separate testing date.[26] The workforce and excludable employees are determined separately for each day. The daily testing method is not very practical and can substantially increase administration costs. This testing method is commonly reserved as an enforcement mechanism for the IRS rather than as a method of choice.

Short Plan Years

The regulations contain no special rules for short plan years (that is, plan years that are less than 12 months long). If the annual testing method is being used, then the workforce is based on the employees during that short plan year and excludable employees are determined accordingly.

[24] Rev. Proc. 93-42, 1993-2 C.B. 540.
[25] Treas. Reg. §1.410(b)-8(a)(3).
[26] Treas. Reg. §1.410(b)-8(a)(2).

Plan Year in Which the Plan Terminates

A coverage test must be performed for the plan year in which the plan terminates only if employees benefit under the plan during the plan year. The plan's termination date does not end the plan year, so the coverage test is still performed for a 12-month plan year (i.e., the plan year in which the termination date falls) unless the final distribution of assets is completed before the last day of that plan year.

STEP 4: DETERMINE HCES AND NHCES IN THE COVERAGE TESTING GROUP

To perform coverage testing, one must identify which employees are HCEs and which employees are NHCEs (see Chapter 4).[27] The NHCEs are any employees who are not HCEs.

STEP 5: DETERMINE THE BENEFITING GROUP

Once the coverage testing group and HCE/NHCE status is determined, the next step is to determine the benefiting group. The **benefiting group** consists of the employees in the coverage testing group who benefit from the plan for the plan year. Whether an employee benefits from the plan depends on the type of plan being tested.

Benefiting under a Defined Contribution Plan

An employee benefits under a defined contribution plan if his or her account balance receives an allocation of employer contributions and/or forfeitures for the plan year.[28] An allocation of trust earnings to the participant's account balance is not sufficient to treat the employee as benefiting.

A defined contribution plan often includes allocation requirements based on service. The most common are 1,000 hours of service during the plan year and/or employment on the last day of the plan year. Once he or she has qualified as a participant in the plan, an employee must satisfy these allocation requirements during each plan year to be entitled to an allocation of employer contributions for that plan year. The same requirements also may apply to the allocation of forfeitures. An employee who does not receive an allocation of employer contributions and/or forfeitures because of these requirements is not benefiting for the plan year.

EXAMPLE 6-15. Last Day Employment Condition on Allocations. A profit sharing plan requires a participant to be employed on the last day of the plan year (December 31) to receive an allocation of employer contributions. Dennis has satisfied the plan's eligibility requirements and is a participant in the plan. On June 5, Dennis terminates employment, after having completed 650 hours of service for the plan year. Dennis does not receive an allocation of employer contributions or forfeitures for the plan year. Dennis is not benefiting for the plan year.

Dennis is in the coverage testing group because he is part of the workforce for the year and is not an excludable employee. (i.e., he has satisfied the plan's age and service requirements for eligibility purposes, and he is credited with more than 500 hours of service for the plan year.) However, Dennis is not part of the benefiting group because he does not benefit under the plan for the plan year. This may affect the plan's ability to pass coverage.

EXAMPLE 6-16. Terminated Employee Completed 500 or Fewer Hours for Plan Year. Suppose in the prior **EXAMPLE 6-15** that Dennis is credited with only 400 hours of service for the plan year.

[27] See, IRC §414(q) and IRS Notice 97-45.

[28] Treas. Reg.§1.410(b)-3(a)(1).

Under the excludable employee definitions, Dennis may be treated as an excludable employee for coverage purposes because he terminated employment during the plan year and has not completed more than 500 hours of service. Dennis would not be part of the coverage testing group, so his failure to benefit would not affect coverage testing.

EXAMPLE 6-17. Earnings Credited to Account Not Relevant. Suppose in the prior **EXAMPLE 6-15** that Dennis' account is credited for its share of trust earnings in the plan year. The crediting of earnings does not cause Dennis to be treated as benefiting under the plan for that plan year.

Benefiting Under a 401(k) or 401(m) Arrangement

If the plan includes a 401(k) arrangement or 401(m) arrangement, those arrangements must be tested separately for coverage and special rules apply to determine who benefits. Under these arrangements, an employee may be treated as benefiting even though he or she receives no contributions that are part of the 401(k) or 401(m) arrangement. This will be discussed in more detail later.

Benefiting Due to Annual Addition Limits

If an allocation is not made for the employee because of the IRC §415 limits, the employee is deemed to benefit for coverage purposes.[29]

EXAMPLE 6-18. Contribution Allocation Limited Due to IRC §415. An employer is testing coverage under its profit sharing plan. The employer also maintains an ESOP. Shaina is a participant in both plans. She is prevented from getting an allocation of employer contributions under the profit sharing plan because her ESOP allocation for the year equals her maximum annual additions limit under IRC §415(c). The plans were designed so that allocations are first reduced under the profit sharing plan to satisfy IRC §415. If Shaina would be otherwise eligible for the allocation, except for the application of the IRC §415(c) limit, Shaina is treated as benefiting under the profit sharing plan for the plan year.

Benefiting Due to Uniform Limitation

If an allocation is not made for the employee because of a uniformly applied limitation under the plan, the employee is deemed to benefit for coverage purposes.[30] For example, if the plan limits an employee's participation to 20 years, the employee would be deemed to benefit after his or her 20th year of participation if he or she otherwise would have qualified for an allocation. This type of provision would be extremely rare in a defined contribution plan.

Top-Heavy Minimums

A non-key employee may have to receive an allocation of employer contributions and forfeitures to satisfy the top-heavy minimum benefit requirements, even though the employee might not otherwise share in such allocations.[31] Sometimes, a participant's top-heavy minimum allocation, as a percentage of compensation, will be less than the allocation rate received by other participants. A participant is benefiting for coverage purposes regardless of whether his or her rate of allocation is the same as that of other participants. However, a difference in allocation rates may affect how the plan is tested for nondiscrimination.

[29] Treas. Reg. §1.410(b)-3(a)(2)(ii)(C).

[30] Treas. Reg. §1.410(b)-3(a)(2)(iii)(B).

[31] IRC §416(c), Treas. Reg. §1.416-1, M-10.

Plan Termination

It is possible that employees will benefit during the plan year in which the plan terminates. This might occur because a final allocation of employer contributions and/or forfeitures is made for the plan year in which the termination date falls, or for the portion of the plan year preceding the termination date, the plan included a 401(k) arrangement in which employees were eligible to participate. The termination date does not end the plan year so the coverage test applies to the normal plan year cycle, unless the final distribution of assets is completed before the end of that plan year. For plan years that begin after the termination date, no coverage testing is performed because no employees will benefit under the defined contribution plan in those years.

If You're Curious . . .

Exclusion with Discriminatory Intent

It should be noted that, even though the coverage testing rules are mathematical, an internal directive at the IRS has raised a subjective discriminatory intent concept as an overlay on the mathematical rules. This directive could result in a challenge to plan provisions that exclude a significant percentage of the NHCEs, particularly if the NHCEs who are covered by the plan are only short-term service employees.

Election Out of Plan

If an employee has elected out of participation in a plan, he or she is not an excluded employee for coverage purposes unless one of the categories of excludable employees applies. Furthermore, he or she is not benefiting because no benefit accrues. Therefore, such an employee who is part of the coverage testing group may affect the plan's ability to satisfy coverage requirements, even though the decision to elect out was made by the employee. This rule applies only with respect to employer contributions (i.e., other than elective contributions and matching contributions) or forfeitures that are not allocated to the employee because he or she elects not to participate.

Sometimes a plan will make an irrevocable waiver available to an employee so that, pursuant to Treas. Reg. §1.401(k)-1(a)(3), the employee's election not to receive or to a receive a reduced level of employer contributions does not cause the employer contributions to be treated as made pursuant to a cash or deferred election. This does not create a different result. For coverage testing purposes, the employee is still included in the coverage testing group and is treated as not benefiting for coverage testing purposes.

Note that an employee who has irrevocably waived participation in a 401(k) plan is treated as not benefiting under that 401(k) arrangement, or in any 401(m) arrangement in which the employee has irrevocably elected not to participate. This is different from the treatment given to an employee who has elected out of the 401(k) arrangement on a revocable basis (i.e., someone who could participate in the plan at his or her or her will but chooses not to do so or has simply chosen not to make elective contributions).[32]

Different Levels of Contributions or Benefits

Some plans are designed so that the eligible participants receive different levels of employer contributions (e.g., a different allocation rate expressed as a percentage of compensation) or accrue benefits under different formulas. Sometimes these formulas are designed to favor a targeted group of participants over other participants. The difference in contri-

[32] See the definition of eligible employee in Treas. Reg.§1.401(k)-6.

bution levels or benefit levels also may be due to the top-heavy rules.

When testing coverage, an employee is benefiting when he or she receives an allocation of employer contributions or accrues an additional benefit under a benefit formula, regardless of whether his or her allocation rate or benefit accrual rate is the same as other participants. A difference in allocation rates or accrual rates is a nondiscrimination testing issue under IRC §401(a)(4), NOT a coverage testing issue under IRC §410(b). Coverage testing generally examines how many NHCEs are benefiting under the plan, regardless of the amount they received. Nondiscrimination testing under IRC §401(a)(4) examines how much those NHCEs received.

EXAMPLE 6-19. New Comparability Plan. A profit sharing plan provides for separate allocations of employer contributions to HCEs and NHCEs. For the current plan year, the HCEs receive an allocation rate of 18 percent of compensation and the NHCEs receive an allocation rate of 5 percent of compensation. When testing coverage, the NHCEs who receive the 5 percent allocation are benefiting under the plan. The fact that their allocation rate is much less than the allocation rate of the HCEs is irrelevant in treating them as benefiting. However, the plan must be able to show through testing that it can satisfy the nondiscrimination requirements of IRC §401(a)(4).

EXAMPLE 6-20. Participating Employers Contributing at Different Levels. Companies X, Y and Z constitute a controlled group of businesses under IRC §414(b). (Remember: Related employers are treated as a single employer for coverage testing purposes.) They all participate in the same profit sharing plan, but each company contributes at a different level. For the current plan year, Company X employees who are eligible for the plan receive an employer contribution allocation equal to 5 percent of compensation. However, Company Y employees who are eligible for the plan get an 8 percent allocation rate and Company Z employees who are eligible for the plan get only a 4 percent allocation rate. For coverage testing purposes, all employees of Companies X, Y and Z who receive their respective allocations of employer contributions are benefiting, regardless of the fact that the allocation rates are not equal. As under the prior **EXAMPLE 6-19**, the differences in allocation rates are tested for nondiscrimination purposes under IRC §401(a)(4).

EXAMPLE 6-21. Top-Heavy Minimum Allocation. Barb and Dave are two non-key employees participating in a profit sharing plan. The plan provides that, to get an allocation of employer contributions, a participant must be credited with at least 1,000 hours of service for the plan year. Barb and Dave satisfied the plan's eligibility requirements and became participants in the plan effective January 1. For the current plan year, Barb and Dave are each credited with fewer than 1,000 hours due to work schedule changes, so they do not share in the regular employer contribution allocations for that year.

However, the plan is top-heavy and Barb and Dave are non-key employees. Because they are employed on the last day of the current plan year, they receive the top-heavy minimum allocation of 3 percent. All of the other participants who completed the 1,000-hour allocation requirement for the current year receive an employer contribution equal to 9 percent of compensation. When testing coverage, Barb and Dave are considered to be benefiting, even though their allocation rate is only 3 percent and the other participants' allocation rate is 9 percent. Again, the amount of their allocation is a nondiscrimination testing issue under IRC §401(a)(4) and not a coverage issue under IRC §410(b).

STEP 6: PERFORM THE RATIO PERCENTAGE TEST

The ratio percentage test is the first of the two coverage tests available to a plan. It also is the simpler of the two to perform. Most plans cover enough NHCEs to satisfy the ratio percentage test. The **ratio percentage test** is satisfied if the

plan's ratio percentage is at least 70 percent.[33]

Ratio Percentage

The plan's **ratio percentage** is determined by dividing the NHCE ratio by the HCE ratio. The ratio percentage must be rounded to the nearest one-hundredth percent.[34]

NHCE Ratio

The **NHCE ratio** is the number of NHCEs in the benefiting group divided by the number of nonexcludable NHCEs in the coverage testing group.

HCE Ratio

The **HCE ratio** is the number of HCEs in the benefiting group divided by the number of nonexcludable HCEs in the coverage testing group.

If the number of employees in the benefiting group equals the number of employees in the coverage testing group, the plan passes the ratio percentage test and calculation of the NHCE and HCE ratios is unnecessary. Also, if the NHCE ratio alone is at least 70 percent, the plan passes the ratio percentage test and calculation of the HCE ratio is unnecessary.

Illustrations of the Ratio Percentage Test

EXAMPLE 6-22. All Eligible Participants are Benefiting. A profit sharing plan's eligibility conditions are age 21 and one year of service. The entry dates are January 1 and July 1. The plan year is the calendar year. The corporation maintaining the plan has 28 total employees during the plan year. There are no union employees or nonresident alien employees. To receive an allocation of profit sharing contributions, a participant must complete at least 1,000 hours of service for the plan year and must be employed on December 31. You have the following information for the current plan year:

		HCEs	NHCEs	Total
a	Workforce during plan year			28
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			6
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			0
d	Coverage testing group [(a) - (b) - (c)]	3	19	22
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year			0
f	Benefiting group [(d) - (e)]	3	19	22
g	Coverage Ratios [(f)/(d)]	100%	100%	
h	Ratio Percentage [(g) for NHCE/(g) for HCE]			100%

The plan passes the ratio percentage test because the ratio percentage is at least 70 percent. All steps were shown here for illustration purposes. Actually, the test can stop at step (f) because the benefiting group equals the coverage testing group.

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[33] Treas. Reg. §1.410(b)-2(b)(2).

[34] Treas. Reg. §1.410(b)-9.

EXAMPLE 6-23. Some Participants Terminate During Plan Year. Suppose in the prior **EXAMPLE 6-22** that several NHCEs terminate during the plan year. The employee information now is as follows:

		HCEs	NHCEs	Total
a	Workforce during plan year			28
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			6
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			2
d	Coverage testing group [(a) - (b) - (c)]	3	17	20
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	0	5	5
f	Benefiting group [(d) - (e)]	3	12	15
g	Coverage Ratios [(f)/(d)]	100%	70.59%	
h	Ratio Percentage [(g) for NHCE/(g) for HCE]			70.59%

The plan passes the ratio percentage test because the ratio percentage is at least 70 percent. All steps were shown here for illustration purposes. Actually, the test can stop at step (g) because the NHCE ratio is at least 70 percent.

This example illustrates the potential impact the allocation requirements can have. The seven participants who did not qualify for allocations because they terminated during the plan year affected the numbers included in the coverage testing group and benefiting group and the resulting ratios. The plan passes the ratio percentage test in this example, but by an extremely thin margin. If one more NHCE participant had terminated with more than 500 hours of service, the plan's ratio percentage would have been less than 70 percent.

EXAMPLE 6-24. Excluded Classification. A profit sharing plan's eligibility conditions are age 21 and one year of service. The employer's workforce is divided into Division A and Division B. The plan excludes employees of Division B. The entry dates are January 1 and July 1. The plan year is the calendar year. The corporation maintaining the plan has 60 total employees during the current plan year. There are no union employees or nonresident alien employees. To receive an allocation of profit sharing contributions, a participant must complete at least 1,000 hours of service for the plan year and must be employed on December 31. You have the following information:

		HCEs	NHCEs	Total
a	Workforce during plan year			60
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			5
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			2
d	Coverage testing group [(a) - (b) - (c)]	8	45	53
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who: (i) are excluded due to employment in Division B; or (ii) terminated before year end with more than 500 hours of service credited during plan year	2	20	22
f	Benefiting group [(d) - (e)]	6	25	31
g	Coverage Ratios [(f)/(d)]	75.00%	55.56%	
h	Ratio Percentage [(g) for NHCE/(g) for HCE]			74.08%

The plan passes the ratio percentage test because the ratio percentage is at least 70 percent. Note the exclusion of Division B employees affected the number of employees in the benefiting group. The allocation requirements of 1,000 hours and last-day employment affected the number of employees in the coverage testing group and the benefiting group. The plan passes the ratio percentage test in this example, but there is only a small cushion above the 70 percent minimum required.

More Examples of Ratio Percentage Test

The following illustrations are provided not only to show how the ratio percentage test is satisfied, but also how to use the worksheet that is provided in section 6.06 of this chapter to perform these mathematical calculations. In each example, we are assuming that the allocations of employer contributions under a profit sharing plan are being tested for coverage. Note that, if the profit sharing plan in the examples included a 401(k) arrangement, a separate coverage test would be performed on the 401(k) arrangement and, if there are matching contributions [i.e., a 401(m) arrangement], a separate coverage test would also be performed on the 401(m) arrangement. The numbers of employees in the coverage testing group and in the benefiting group could be different under these arrangements from the numbers shown in the worksheets for these examples with respect to the profit sharing contribution.

EXAMPLE 6-25. Safe Harbor Accrual Requirements Make Coverage Failure Impossible. A profit sharing plan's eligibility requirements are one year of service and age 21. Profit sharing contributions made for a plan year are allocated only to the accounts of participants who satisfy either of the following requirements: i) employed by the employer at the end of the year, or ii) credited with more than 500 hours of service for the plan year. Note that these allocation requirements are safe harbor accrual requirements for nondiscrimination testing purposes. The employer has 15 employees during the current plan year. None of the employees is a union employee or a nonresident alien. Based on the following information, does the profit sharing plan pass the ratio percentage test under IRC §410(b)?

a	Workforce during plan year	15
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates	2
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service	1
		Total
d	Coverage testing group [(a) - (b) - (c)]	12
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	0
f	Benefiting group [(d) - (e)]	12

Because the entire coverage testing group benefits, coverage is 100 percent and the ratio percentage test is passed. This will always be the case, because the plan's allocation requirements are safe harbors for coverage purposes. Therefore, we do not need to calculate the ratio percentages for the HCEs and NHCEs.

EXAMPLE 6-26. At Least 70 Percent of NHCEs Benefit. A non-top-heavy profit sharing plan's eligibility requirements are one year of service and age 21. An employee becomes a participant on the January 1 or July 1 that first follows his completion of these eligibility requirements. Profit sharing contributions made for a plan year are allocated only to the accounts of participants who satisfy both of the following requirements:

a. Employed by the employer on the last day of the plan year (December 31), and

b. Credited with at least 1,000 hours of service for the plan year.

The employer has 25 employees during the current plan year. None of the employees is a union employee or a nonresident alien. Based on the following information, does the profit sharing plan pass the ratio percentage test under IRC §410(b)?

	Employee Information	
a	Total Employees	25: 4 HCEs, 21 NHCEs
b	Did not satisfy age/service requirements	6: 1 HCE, 5 NHCEs
c	Not benefiting because not employed on last day of the plan year and credited with 500 or fewer hours of service	1 NHCE
d	Not benefiting because not employed on last day of the plan year and credited with more than 500 hours of service	2 NHCEs
e	Employed at year end and credited with 1,000 or more hours of service	15: 3 HCEs, 12 NHCEs
f	Employed at year end and credited with fewer than 1,000 hours of service	1 NHCE

Only participants in (e) receive allocations of employer contributions for the plan year (i.e., these are the employees who are benefiting under the plan for the plan year in question).

The participant in (f) is not excluded under (b) because he has satisfied the plan's one year of service requirement and has qualified as a participant. He or she just has not been credited with at least 1,000 hours of service in this plan year. For example, suppose this employee started work on April 1, 2016, and worked 100 hours per month for all of 2016 and 2017, but now his work schedule has changed and he has been working 70 hours per month since January 1, 2018. This employee is not in line (b), because he or she satisfied the eligibility requirements on March 31, 2017 (i.e., had 1,200 hours of service in his first eligibility computation period) and became a participant on July 1, 2017. Because of his change of work schedule, he completes only 840 hours in the current plan year.

	Coverage Test Worksheet			
a	Workforce during plan year			25
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			6
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			1
		HCEs	NHCEs	Total
d	Coverage testing group [(a) - (b) - (c)]	3	15	18
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	0	2	2
	Number of employees in (d) who are employed at year end but completed fewer than 1,000 hours	0	1	1
f	Benefiting group [(d) - (e)]	3	12	15
g	Coverage Ratios [(f)/(d)]	100%	80%	
h	Ratio Percentage [(g) for NHCE/(g) for HCE]			80%

Ratio percentage test passed!

In this example, it is noted that the plan is not top-heavy. If the plan was top-heavy, the one NHCE in line (f) of the employee information would receive a top-heavy minimum allocation (if he were non-key), so he or she would be included in the benefiting group. This would make the ratio percentage higher. The NHCE ratio would be 13/15, or 86.67 percent.

EXAMPLE 6-27. Less Than 70 Percent of NHCEs Benefit But Ratio Percentage Test is Passed Because NHCE Ratio is Not Less Than 70 Percent of the HCE Ratio. A profit sharing plan's eligibility requirements are one year of service and age 21. An employee becomes a participant on the January 1 or July 1 that first follows his completion of these eligibility requirements. None of the employees is a union employee or a nonresident alien. Profit sharing contributions made for a plan year are allocated only to the accounts of participants who satisfy both of the following requirements:

a. Employed by the employer on the last day of the plan year; and

b. Credited with at least 1,000 hours of service for the plan year.

	Employee Information	
a	Total Employees	32: 6 HCEs, 26 NHCEs
b	Did not satisfy age/service requirements	7: 1 HCE, 6 NHCEs
c	Not benefiting because not employed on last day of the plan year and credited with 500 or fewer hours of service	1 NHCE
d	Not benefiting because not employed on last day of the plan year and credited with more than 500 hours of service	8: 1 HCE, 7 NHCEs
e	Employed at year end and credited with 1,000 or more hours of service	16: 4 HCEs, 12 NHCEs
f	Employed at year end and credited with fewer than 1,000 hours of service	0

	Coverage Test Worksheet			
a	Workforce during plan year			32
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			7
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			1
		HCEs	NHCEs	Total
d	Coverage testing group [(a) - (b) - (c)]	5	19	24
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	1	7	8
	Number of employees in (d) who are employed at year end but completed fewer than 1,000 hours	0	0	0
f	Benefiting group [(d) - (e)]	4	12	16
g	Coverage Ratios [(f)/(d)]	80%	63.16%	
h	Ratio Percentage [(g) for NHCE/(g) for HCE]			78.95%

Ratio percentage test is passed!

EXAMPLE 6-28. High Turnover Causes Plan to Fail Ratio Percentage Test Because of Last-Day Employment Condition for Allocations. A profit sharing plan's eligibility requirements are one year of service and age 21. An employee becomes a participant on the January 1 or July 1 that first follows his completion of these eligibility requirements. Profit sharing contributions made for a plan year are allocated only to the accounts of participants who satisfy both of the following requirements:

a. Employed by the employer on the last day of the plan year, and

b. Credited with at least 1,000 hours of service for the plan year.

The employer has 130 employees during the current plan year. None of the employees is a union em-

ployee or a nonresident alien. The workforce is highly volatile. Based on the following information, does the profit sharing plan pass the ratio percentage test under IRC §410(b)?

	Employee Information	
a	Total Employees	130: 16 HCEs, 114 NHCEs
b	Did not satisfy age/service requirements	37: 2 HCEs, 35 NHCEs
c	Not benefiting because not employed on last day of the plan year and credited with 500 or fewer hours of service	8 NHCEs
d	Not benefiting because not employed on last day of the plan year and credited with more than 500 hours of service	29: 1 HCE, 28 NHCEs
e	Employed at year end and credited with 1,000 or more hours of service	56: 13 HCEs, 43 NHCEs
f	Employed at year end and credited with fewer than 1,000 hours of service	0

	Coverage Test Worksheet			
a	Workforce during plan year			130
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			37
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			8
		HCEs	NHCEs	Total
d	Coverage testing group [(a) - (b) - (c)]	14	71	85
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	1	28	29
	Number of employees in (d) who are employed at year end but completed fewer than 1,000 hours	0	0	0
f	Benefiting group [(d) - (e)]	13	43	56
g	Coverage Ratios [(f)/(d)]	92.86%	60.56%	
h	Ratio Percentage [(g) for NHCE/(g) for HCE]			65.22%

Ratio percentage test failed!

OPTIONS FOR EMPLOYER AS A RESULT OF THE FAILURE OF THE TEST

A plan sponsor faced with a failed ratio percentage test has two choices to solve the problem and to keep the plan qualified:

1. Increase the ratio percentage by plan amendment (i.e., make a contribution for additional NHCEs), or
2. Perform the average benefit test.

As noted earlier, some plans include a fail-safe provision in which employees who fail to benefit under the plan's normal accrual requirements are added to the allocation group to pass the coverage test. An ordering rule is usually provided for bringing in employees. For example, the plan might require that NHCEs included in line (d) (terminated participants who worked more than 500 hours during the plan year) be brought into the allocation in reverse order of their termination dates, until the ratio percentage equals at least 70 percent. To reach at least 70 percent, the plan in EXAMPLE 6-28 would need 47, rather than 43, NHCEs benefiting in line (f) above, so the four NHCEs shown in line (d) that left latest in the year would be added to the allocation. Such provisions usually are structured to guarantee that the ratio percentage test is satisfied. If the plan includes such a provision, the administrator would be required to follow that provision. This would make a plan amendment unnecessary (because the plan already provides for the adjustment) and the average benefit test would be unavailable.

EXAMPLE 6-29. Job Category Exclusion Leaves Little Cushion for Passing Ratio Percentage Test. A profit sharing plan's eligibility requirements are one year of service and age 21. In addition, hourly-paid employees are excluded. There are no union employees and no nonresident aliens. An employee becomes a participant on the January 1 or July 1 that first follows his completion of these eligibility requirements. Profit sharing contributions made for a plan year are allocated only to the accounts of participants who satisfy both of the following requirements:

a. Employed by the employer on the last day of the plan year, and

b. Credited with at least 1,000 hours of service for the plan year.

The employer has 175 employees during the current plan year. Based on the following information, does the profit sharing plan pass the ratio percentage test under IRC §410(b)?

	Employee Information	
a	Total Employees	175: 21 HCEs, 154 NHCEs
b	Did not satisfy age/service requirements	42: 2 HCEs, 40 NHCEs
c	Not benefiting because not employed on last day of the plan year and credited with 500 or fewer hours of service	3 NHCEs
d	Not benefiting because not employed on last day of the plan year and credited with more than 500 hours of service	11: 1 HCE, 10 NHCEs
e	Not benefiting because hourly paid	24 NHCEs
f	Employed at year end and credited with 1,000 or more hours of service	95: 18 HCEs, 77 NHCEs
g	Employed at year end and credited with fewer than 1,000 hours of service	0

	Coverage Test Worksheet			
a	Workforce during plan year			175
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			42
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			3
		HCEs	NHCEs	Total
d	Coverage testing group [(a) - (b) - (c)]	19	111	130
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	1	10	11
	Number of employees in excluded class (i.e., hourly paid)	0	24	24
	Number of employees in (d) who are employed at year end but completed fewer than 1,000 hours	0	0	0
f	Benefiting group [(d) - (e)]	18	77	95
g	Coverage Ratios [(f)/(d)]	94.74%	69.37%	
h	Ratio Percentage [(g) for NHCE/(g) for HCE]			73.22%

Ratio percentage test passed, but with little room to spare. The turnover rate of salaried employees is an important issue.

THE AVERAGE BENEFIT TEST

If the plan fails the ratio percentage test and the plan document does not include fail-safe provisions, the employer has two choices:

1. Expand coverage to pass the ratio percentage test; or
2. Pass the average benefit test.

This section explains generally how the average benefit test is done. A more detailed discussion of the average benefits test is found in *The ASPPA Defined Contribution Plan Series Volume 3: Advanced Compliance and Administration Topics*, available through the ASPPA bookstore at ecommerce.asppa-net.org.

Two-Part Test

There are two parts to the **average benefit test**. The first part is the **nondiscriminatory classification test** and the second part is the **average benefit percentage test**. The nondiscriminatory classification test looks at whether the employees who benefit under the plan represent a reasonable and nondiscriminatory group. The average benefit percentage test compares the average rate of benefits provided to HCEs with that of NHCEs to ensure that the rate of benefiting is reasonable and not discriminatory. The information used to run the ratio percentage test is exactly the same information needed to run the nondiscriminatory classification test. However, specific information about the allocation or benefits provided to the employees is necessary to run the average benefit percentage test. Both parts of the test must be satisfied for the plan to pass the average benefit test.

Section 6.04: Special Coverage Rules

Many situations require the application of special coverage testing rules. These special rules are discussed below.

COVERAGE TESTING FOR 401(k) AND 401(m) PLANS

Under a 401(k) arrangement, an employee may make elective contributions to the plan. A 401(m) arrangement includes after-tax employee contributions and matching contributions made by an employer. Matching contributions may apply to elective contributions or after-tax employee contributions.

Mandatory Disaggregation

Treasury Regulations require the employer to disaggregate the 401(k) arrangement and the 401(m) arrangement to test coverage.[35] This means each disaggregated portion is treated as if it were a separate plan for purposes of testing coverage. A plan that includes a 401(k) arrangement may consist of up to three plans for coverage testing:

1. The 401(k) plan;
2. The 401(m) plan; and
3. The non-401(k)/non-401(m) plan [which we will refer to as the 401(a) plan].

The 401(a) part of the plan is the part of the plan representing employer nonelective contributions to the profit sharing plan or stock bonus plan that contains the 401(k) arrangement. Any reference below to 401(k) plan means the 401(k) portion (elective contributions) of a plan and any reference below to 401(m) plan means the 401(m) (after-tax employee or matching contributions) portion of the plan.

If You're Curious . . .

Qualified matching contributions (QMACs) are permitted to be tested for nondiscrimination under the ADP test, along with the elective deferrals, rather than being tested under the ACP test [under IRC §401(m)].[36] However, for coverage testing purposes, QMACs are always part of the 401(m) plan,

[35] Treas. Reg.§1.410(b)-7(c)(1).

[36] Treas. Reg. §1.401(k)-2(a)(6).

regardless of whether they are included in the ADP test or the ACP test.[37]

Elective deferrals may be included in the ACP test under certain circumstances.[38] However, similar to the rule for QMACs that is described in the prior paragraph, elective deferrals are always part of the 401(k) plan for coverage testing purposes, even if they are included in the ACP test for nondiscrimination testing purposes.[39]

Certain employer contributions, known as qualified nonelective contributions (QNECs), may be used in either the ADP test or the ACP test.[40] However, for coverage testing purposes, QNECs are neither part of the 401(k) plan nor part of the 401(m) plan. Instead, QNECs are part of the 401(a) portion of the plan, along with any other employer nonelective contributions allocated for the plan year, for coverage testing purposes, regardless of whether the QNECs are included in the ADP test or ACP test.[41]

There is no special exception from coverage testing merely because a 401(k) plan is a safe harbor plan, within the meaning of IRC §401(k)(12). The safe harbor rule merely excuses the 401(k) arrangement from the ADP test, not from the coverage test. The plan still must cover a group of employees that can satisfy one of the coverage tests under IRC §410(b).

If You're Curious . . .

For coverage testing purposes, the disaggregated 401(k) plan consists solely of the elective deferrals, and includes neither the safe harbor matching contributions, as described in IRC §401(k)(12)(B), nor the safe harbor nonelective contributions, as described in IRC §401(k)(12)(C), made by the employer. The disaggregated 401(m) plan, for coverage testing purposes, consists solely of the matching contributions and after-tax employee contributions, if any, regardless of whether the matching contributions are safe harbor matching contributions under IRC §401(k)(12)(B), and regardless of whether the matching contributions satisfy the ACP safe harbor under IRC §401(m)(11). For coverage testing purposes, the 401(a) portion of the plan includes all nonelective contributions made by the employer, regardless of whether the nonelective contributions (or a portion thereof) are safe harbor nonelective contributions described in IRC §401(k)(12)(C).

Below is a summary of where each type of contribution is tested for IRC §410(b) coverage purposes under the mandatory disaggregation rules:

	Test Under 401(k) Portion?	Test Under 401(m) Portion?	Test Under 401(a) Portion?
Elective deferrals	☑		
After-tax employee contributions		☑	
Nonsafe harbor matching contributions		☑	
Safe harbor matching contributions		☑	
QMACs		☑	
Employer nonelective contributions			☑
QNECs			☑
Safe harbor nonelective contributions			☑

[37] See the definition of section 401(m) plan in Treas. Reg.§1.410(b)-9.
[38] Treas. Reg. §1.401(m)-2(a)(6).
[39] See the definition of section 401(k) plan in Treas. Reg. §1.410(b)-9.
[40] Treas. Reg. §1.401(k)-2(a)(6).
[41] See the definitions of section 401(k) plan and section 401(m) plan in Treas. Reg.§1.410(b)-9.

Testing the Disaggregated Parts of the Plan

The coverage testing group is separately determined for each disaggregated portion of the plan, based on who is an excludable employee with respect to that portion of the plan (e.g., age and service conditions applicable to the disaggregated portion of the plan). The benefiting group includes only the employees who benefit under the disaggregated portion of the plan being tested. For example, when testing the 401(k) plan, only the employees who are benefiting under the 401(k) arrangement are included in the benefiting group. Testing a 401(k) plan for coverage is discussed in depth in *The ASPPA Defined Contribution Plan Series Volume 2: 401(k) Plans and Intermediate Administration Topics*, available through the ASPPA bookstore at ecommerce.asppa-net.org.

PERMISSIVE AGGREGATION OF PLANS

When an employer maintains two or more plans, it usually tests each plan separately for coverage purposes. As an alternative, the employer may aggregate one plan with one or more other plans and treat all of the plans as a single plan for testing purposes.[42] The aggregation of two or more plans to pass coverage is known as permissive aggregation, because the employer elects to use this testing option.

Plans may not be permissively aggregated unless they have the same plan year. Furthermore, only qualified plans under IRC §401(a) are eligible for permissive aggregation. An employer may not aggregate a qualified plan with a 403(b) plan or a SEP to demonstrate that the qualified plan passes the coverage test under IRC §410(b).

Plans are not treated as permissively aggregated unless they are aggregated to perform the ratio percentage test or the nondiscriminatory classification test portion of the average benefit test.[43] Permissive aggregation might be used when one of the employer's plans fails the ratio percentage test and the employer does not want to rely on the average benefit test to show coverage is satisfied. Permissive aggregation also might be used when a plan is unable to pass the nondiscriminatory classification test portion of the average benefit test, but may pass if it is permissively aggregated with another plan maintained by the employer.

Testing a plan separately for coverage purposes means that, when determining the benefiting group for purposes of the ratio percentage test, only employees benefiting under the plan being tested are included in the benefiting group. When plans are permissively aggregated, the benefiting group is determined by taking into account any employee who benefits under any of the plans being aggregated.

When plans are permissively aggregated, the coverage testing group is generally not affected. That is because the coverage testing group is determined with reference to the entire workforce, not just the group of employees who are benefiting under a particular plan. Only employees who are excludable employees within the meaning of IRC §410(b)(3) and (4) are excluded from the coverage testing group. However, if the eligibility age and service requirements are different under the plans being permissively aggregated, the rule discussed above under which the excludable group is determined with reference to the most lenient eligibility requirements applies. As a result, the coverage testing group may be different on an aggregated basis than it would be if one of the plans were tested separately for coverage.

ELECTIVE DISAGGREGATION

Under certain circumstances, an employer may elect to disaggregate certain groups of employees and perform IRC §410(b) coverage testing separately for each group. Examples of when elective disaggregation may be available to an employer include the following:

QSLOBs

If a plan covers employees in more than one qualified separate line of business (QSLOB), the plan may be disaggregated

[42] Treas. Reg. §1.410(b)-7(d).
[43] Treas. Reg. §1.410(b)-7(d)(1).

into separate portions representing employees assigned to each QSLOB. A company may be divided into QSLOBs if certain criteria are satisfied.[44] These criteria are designed to ensure that the company is divided into different parts that truly operate in a manner that is so decentralized and separate that they resemble separate companies entirely.

If You're Curious . . .

Each QSLOB must have at least 50 employees; therefore, a QSLOB structure is not effective for companies with fewer than 100 employees. Furthermore, each employee must be assigned to a certain QSLOB within the company, with relatively few cross-services permitted. Again, this reflects the separateness of each of the sub-entities in the company.

When applying the coverage tests to a plan maintained by a QSLOB, all employees not included in that QSLOB are excludable employees.[45] If a plan covers employees in more than one QSLOB, and the employer has elected to test plans separately on a QSLOB basis, the disaggregation rules described below apply.[46] Under QSLOB-testing, each QSLOB separately determines its workforce, its coverage testing group (employees of other QSLOBs are excludable employees), its ratio percentage and, if applicable, its average benefit percentage for the average benefit test. The use of QSLOBs for coverage testing is discussed in depth in *The ASPPA Defined Contribution Plan Series Volume 3: Advanced Compliance and Administration Topics*, available through the ASPPA bookstore at ecommerce.asppa-net.org.

Otherwise Excludable Employees

An elective disaggregation rule is provided for otherwise excludable employees. Although this disaggregation rule is elective, it is easy to get confused because the Regulations list it under mandatory disaggregation.

Separate Testing of Otherwise Excludable Employees

When determining the coverage testing group, the employees who have not satisfied the plan's age and service requirements are excluded. If the plan's age and service requirements are more liberal than the statutory requirements of age 21 or one year of service, the plan is covering employees it otherwise could exclude from the coverage testing group. For example, a plan with a six-month eligibility condition is covering employees that would have been excluded under a one-year-of-service condition. These employees are known as **otherwise excludable employees**.

Under a special testing rule provided in Treas. Reg. §1.410(b)-7(c)(3), the employer is permitted to disaggregate the portion of the plan covering the otherwise excludable employees from the rest of the employees (the **statutory employees**). All coverage testing is done separately for the otherwise excludable employees and for the statutory employees, as if they were in separate plans.

Unlike the other mandatory disaggregation rules, testing otherwise excludable employees separately is elective. The employer may choose to run coverage testing without disaggregating statutory employees from otherwise excludable employees and perform a single coverage test that takes into consideration both groups of employees in determining the coverage testing group and the coverage testing results.

If You're Curious . . .

The statutory entry date rules in IRC §410(a)(4) provide that, once the statutory age and service requirements are satisfied, the employee must become a participant no later than the first day of the next plan year or, if earlier, the date which is six months from completing the statutory requirements. If the plan uses entry dates that would make an employee a participant sooner than the statutory

[44] See Treas. Reg. §1.414(r)-1, et. seq.

[45] Treas. Reg. §1.410(b)-6(e).

[46] Treas. Reg. §1.410(b)-7(c)(4)(ii)(A).

entry dates would make him or her a participant (e.g., quarterly entry dates), should the plan's entry dates be used to delineate between otherwise excludable employees and statutory employees under this disaggregated testing rule? It is not clear under the Regulations. There are two approaches, both of which should be considered reasonable in the absence of clear regulations.

Approach 1: Use Statutory Entry Dates to Determine Otherwise Excludable Employees

Under this approach, the plan's entry dates are ignored to identify otherwise excludable employees. Any employee who would not be a participant at any time during the plan year if the statutory entry dates under IRC §410(a)(4) were used in conjunction with the statutory age and service requirements, is treated as an otherwise excludable employee. Because IRC §410(a)(4) uses the earlier of the first day of the next plan year or six months from completing the statutory requirements as its default entry date, an otherwise excludable employee under this approach is any employee who, as of the last day of the sixth month of the plan year, has not reached age 21 and has not completed a year of service.

Approach 2: Use Plan's Entry Dates

Under this approach the plan's entry dates are taken into consideration. Any employee who would not be a participant at any time during the plan year if the plan's entry dates were used in conjunction with the statutory age and service requirements is treated as an otherwise excludable employee. An otherwise excludable employee under this approach is any employee who would not have become a participant as of the last entry date stated in the plan document if the plan had used the statutory age and service requirements. Some IRS representatives informally have indicated a preference for this approach in speeches to the benefits community.

Determining the Coverage Testing Group for the Disaggregated Plans

When testing the portion of the plan covering otherwise excludable employees, the statutory employees are excluded from the coverage testing group. Also, any employees who fail to satisfy the age and service requirements imposed on the otherwise excludable employees are excluded from the coverage testing group. For example, if the plan requires three months of service for eligibility, any employee who has not satisfied the three months of service requirement for the plan year, as well as any employee who satisfies the statutory age and service requirements, is an excludable employee when determining the coverage testing group for the disaggregated plan that covers the otherwise excludable employees. When testing the portion of the plan covering the statutory employees, all employees who fail to satisfy the statutory age and service requirements are excluded from the coverage testing group, including the otherwise excludable employees who are eligible for the plan but who were tested separately.

If an employer disaggregates otherwise excludable employees to run coverage testing for the plan year, it is not required to take the same approach in the next plan year. The decision to use otherwise excludable employee disaggregation is made on a year-by-year basis.

Plan Using Two-Year Eligibility Rule

This special testing option does not apply with reference to the two-year eligibility rule that is permitted under IRC §410(a)(1)(B). For example, a profit sharing plan may not define otherwise excludable employees to mean employees who are eligible for the plan but would be excluded if the plan imposed a two-year eligibility requirement.

EXAMPLE 6-30. COMPARING DISAGGREGATED PLAN TO SINGLE PLAN. A profit sharing plan's eligibility conditions are age 21 and six months of service.

Coverage test run without disaggregating otherwisese excludable employees. Suppose the employer does not disaggregate otherwise excludable employees. The plan fails the ratio percentage test, based on the following facts:

	Employee Information	
a	Total Employees	30: 5 HCEs, 25 NHCEs
b	Did not satisfy age/service requirements	2 NHCEs
c	Not benefiting because not employed on last day of the plan year and credited with 500 or fewer hours of service	1 NHCE
d	Not benefiting because not employed on last day of the plan year and credited with more than 500 hours of service	9 NHCEs
e	Employed at year end and credited with 1,000 or more hours of service	18: 5 HCEs, 13 NHCEs
f	Employed at year end and credited with fewer than 1,000 hours of service	0

	Coverage Test Worksheet			
a	Workforce during plan year			30
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			2
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			1
		HCEs	NHCEs	Total
d	Coverage testing group [(a) - (b) - (c)]	5	22	27
e	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	0	9	9
	Number of employees in (d) who are employed at year end but completed fewer than 1,000 hours	0	0	0
f	Benefiting group [(d) - (e)]	5	13	18
g	Coverage Ratios [(f)/(d)]	100%	59.09%	
h	Ratio Percentage [(g) for NHCE/(g) for HCE]			59.09%

Because the terminated employees included in step (e) were all NHCEs, the plan failed the ratio percentage test.

Coverage run by disaggregating otherwise excludable employees. Suppose five of those terminations with more than 500 hours were in the otherwise excludable employee group and all the HCEs satisfy the statutory one-year-of-service requirement. Furthermore, assume that the one terminated participant with fewer than 500 hours of service was an otherwise excludable employee. By disaggregating the plan under this special test, the plan would pass coverage. Here's how the coverage test for the statutory employees would look if otherwise excludable employees were disaggregated from statutory employees.

The coverage worksheet for the statutory employees:

		HCEs	NHCEs	Total
a	Workforce during plan year			30
b	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates			2
c	Number of nonbenefiting employees not included in (b) who terminate before year end with 500 or fewer hours of service			0
d	Number of eligible nonstatutory employees excluded from this test (i.e., would not satisfy one year/age 21 requirements if January 1 or July 1 entry dates were used)			6
e	Coverage testing group [(a) - (b) - (c) - (d)]	5	17	22
f	Employees in the coverage testing group who do not benefit under the plan: Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	0	4	4
	Number of employees in (d) who are employed at year end but completed fewer than 1,000 hours	0	0	0
g	Benefiting group [(e) - (f)]	5	13	18
h	Coverage Ratios [(g)/(e)]	100%	76.47%	
i	Ratio Percentage [(h) for NHCE/(h) for HCE]			76.47%

The ratio percentage for the otherwise excludable employees does not need to be computed because none of the HCEs are otherwise excludable employees. Therefore, that test is automatically satisfied—when no HCEs benefit under a plan (or disaggregated plan), the plan is deemed to satisfy coverage.

If the ratio percentage of the statutory or otherwise excludable employees was less than 70 percent, the average benefit test could be used. If a plan is disaggregated into separate plans for coverage testing under other disaggregation rules, the otherwise excludable employee disaggregation election may be applied separately to each of those disaggregated portions of the plan.

EXAMPLE 6-31. 401(k) Plan. A 401(k) plan consists of three disaggregated components: a 401(k) arrangement, a 401(m) arrangement and employer nonelective contributions. These three components are tested separately for coverage. The otherwise excludable employee disaggregation under Treas. Reg. §1.410(b)-7(c)(3) is made separately for each component, and the election with respect to otherwise excludable employee disaggregation need not be consistent for each disaggregated component.

The employer elects to disaggregate otherwise excludable employees for the 401(k) and 401(m) components, so that it will be able to exclude the otherwise excludable NHCEs under the applicable nondiscrimination tests (i.e., ADP and ACP tests), pursuant to IRC §§401(k)(3)(F) and 401(m)(5)(C). However, the employer does not elect to disaggregate otherwise excludable employees for the nonelective contribution component.

There will be five coverage tests performed with respect to the 401(k) plan for this plan year. For the 401(k) arrangement, there are two coverage tests—one for the otherwise excludable employees and one for the statutory employees. For the 401(m) arrangement, there are also two coverage tests—one for the otherwise excludable employees and one for the statutory employees. However, for the nonelective contribution component, there is only one coverage test. When determining the coverage testing group for the nonelective contribution component, only employees who fail to satisfy the lowest age and service requirements of the plan are excludable em-

ployees under Treas. Reg. §1.410(b)-6(b)(1). For the 401(k) component and 401(m) components of the plan, separate coverage testing groups for the statutory employees and for the otherwise excludable employees are determined, under the principles described above.

Effect on Nondiscrimination Testing

If plans are disaggregated under this testing rule for coverage purposes, then nondiscrimination testing also must be performed separately for statutory employees and otherwise excludable employees.

DUAL ELIGIBILITY

When a plan has more than one set of eligibility requirements that apply to employees covered by the plan, the plan has **dual eligibility** provisions. To determine excludable employees under that type of plan, the exclusion for employees who fail to satisfy the plan's age/service requirements applies to the lowest age/service requirements applicable to any employee benefiting under the plan for the plan year.[47]

A dual eligibility provision is most common in a plan established for a new business. The plan may provide for immediate entry of employees hired by a certain date (since no employee has completed a year of service), but a one-year-of-service requirement for employees hired after that date.

The operation of the dual eligibility provision may result in an expanded group of employees included in the coverage testing group. This will occur until all the employees subject to the more liberal eligibility rules have satisfied the more restrictive rules applicable to other employees. During that period, the special testing rule for otherwise excludable employees may be of assistance in passing coverage.

If You're Curious . . .

SHARED EMPLOYEES

A shared employee is someone who works for two or more employers that are not part of the same related group. For example, a medical office may house two different medical corporations—Dr. A owning one and Dr. B owning the other. Dr. A and Dr. B each hire the employees for 50 percent of the work and pay 50 percent of the compensation earned by the employees. These employees are shared between the two corporations.

There are currently no regulations addressing the proper treatment of a shared employee. Several pre-ERISA rulings, however, shed some light on the issue.[48]

Coverage of Shared Employee

An employer that receives the services of a shared employee would need to include that employee only to the extent of the compensation paid by that employer.

Service Crediting Requirements

A plan may have service requirements for eligibility, vesting and/or accrual of benefits. In the absence of regulations, it is recommended to aggregate the shared employee's services performed with all the employers to determine if the service requirement is satisfied. For example, suppose a secretary

[47] Treas. Reg. §1.410(b)-6(b)(2).

[48] Rev. Rul. 67-101, 1967-1 C.B. 82, Rev. Rul. 68-370, 1968-2 C.B. 174, Rev. Rul. 68-391, 1968-2 C.B. 180, and Rev. Rul. 73-447, 1973-2 C.B. 135. Note that Rev. Rul. 68-370 was declared obsolete by the IRS, but contains a good discussion of the principles applicable to shared employee situations.

works 1,200 hours of service per year—600 hours for Dr. A and 600 hours for Dr. B. The secretary should be credited with 1,200 hours of service in any plan maintained by either Dr. A or Dr. B, even though 1,200 hours are not provided to any one employer.

COLLECTIVELY BARGAINED PLANS

As noted earlier, a plan covering collective bargaining employees (union employees) is deemed to satisfy coverage.[49] This rule also applies to any disaggregated portion of a plan that includes only union employees.

If a plan covers both union and nonunion employees, each portion of the plan is disaggregated and tested separately. In addition, if the union employees are covered by more than one collective bargaining agreement, the employees covered by each agreement constitute a separate disaggregation population.[50] If a plan covers both union employees and nonunion employees, the portion of the plan that covers union employees is deemed to satisfy coverage, even though the nonunion portion of the plan must demonstrate that it passes coverage.

NO NHCES IN COVERAGE TESTING GROUP

If there are no NHCEs in the coverage testing group, the plan is deemed to satisfy coverage for the plan year.[51]

EXAMPLE 6-32. HCEs Only. Corporation X has five employees, two of whom are equal shareholders of X and the other three are nonowners. Corporation X maintains a profit sharing plan with a one year of service eligibility requirement. For the current plan year, only the two shareholders satisfy the eligibility requirement and are the only participants in the plan. The three nonowners are excludable employees because they fail to satisfy the plan's eligibility service requirement.[52] Because the only employees in the coverage testing group for the plan year are HCEs, the plan is deemed to satisfy coverage.

If there is at least one NHCE in the coverage testing group, this rule does not apply. In **EXAMPLE 6-32** above, if one of the three NHCEs had satisfied the plan's eligibility service requirement, but the plan excluded him or her anyway (under a job classification, for example), the plan would not be deemed to pass coverage under this rule, even though the only eligible employees in the plan are HCEs.

If You're Curious . . .

When plans are permissively aggregated for coverage purposes, as permitted by Treas. Reg. §1.410(b)-7(d), the above rule would not apply unless there are no NHCEs in the coverage testing group determined with respect to all of the aggregated plans.

If plans are disaggregated under Treas. Reg. §1.410(b)-7(c), this rule is applied separately to each disaggregated plan. If there are no NHCEs in the coverage testing group of a disaggregated plan (or disaggregated portion of a plan, such as a disaggregated group of otherwise excludable employees), then the disaggregated plan (or disaggregated portion of a plan) is deemed to satisfy coverage.

NO HCES BENEFITING UNDER PLAN

If there are no HCEs benefiting under the plan, the plan is deemed to satisfy coverage for the plan year.[53]

[49] Treas. Reg. §1.410(b)-2(b)(7).
[50] Treas. Reg. §1.410(b)-7(c)(4)(ii)(B).
[51] Treas. Reg. §1.410(b)-2(b)(5).
[52] Treas. Reg. §1.410(b)-6.
[53] Treas. Reg. §1.410(b)-2(b)(6).

EXAMPLE 6-33. No HCEs Benefiting. G Corporation sponsors a profit sharing plan. The HCEs are excluded from receiving contributions if company profits are below a certain level. For 2016, profits are below that level, so all contributions go to NHCEs. Because only NHCEs benefit under the plan for that year, the plan is deemed to pass coverage.

Implied in this rule is that a frozen plan always satisfies coverage because no one benefits for any plan year in which the plan is frozen. A plan is frozen for a plan year if there are no allocations of contributions or forfeitures, in the case of a defined contribution plan, or no accrual of benefits, in the case of a defined benefit plan.

If an employer does not contribute to a discretionary profit sharing plan (or stock bonus plan) for a plan year, the plan is deemed to satisfy coverage because no one benefits for that plan year. This no-contributions rule for discretionary plans would apply only if there are also no forfeitures allocated for that plan year.

If You're Curious . . .

When plans are permissively aggregated for coverage purposes, as permitted by Treas. Reg. §1.410(b)-7(d), the above rule would not apply unless there are no HCEs benefiting under all of the aggregated plans. If plans are disaggregated under Treas. Reg. §1.410(b)-7(c), this rule is applied separately to each disaggregated plan. If there are no HCEs benefiting under a disaggregated plan (or disaggregated portion of a plan, such as a disaggregated group of otherwise excludable employees), then the disaggregated plan (or disaggregated portion of a plan) is deemed to satisfy coverage.

LEASED EMPLOYEES IN COVERAGE TESTING

In the early part of the chapter, we discussed the inclusion of leased employees in the coverage testing workforce. This rule affects the coverage testing in the following ways.

Determination of Coverage Testing Group

The coverage testing group, for purposes of applying the coverage tests to a plan maintained by the recipient, is determined by including the leased employees in the workforce. A leased employee will be part of the recipient's coverage testing group unless he or she or she falls into one of the excludable employee categories.

Application of Minimum Age/Service Excludable Employee Category

The leased employees will usually satisfy the one year of service requirement under IRC §410(a) because, to be treated as a leased employee, the individual must perform services for the recipient on a substantially full-time basis for at least one year.[54] Therefore, a leased employee will not be an excludable employee under the minimum age and service requirements category unless the plan requires more than one year of service (such as a profit sharing plan that contains a two-year eligibility requirement), or unless the leased employee fails to satisfy the plan's minimum age requirement. Furthermore, if the plan disaggregates otherwise excludable employees, most leased employees will be statutory employees, because they will have, by definition, performed services for a year. Therefore, the leased employees usually will not be in the disaggregated portion of the plan that covers the otherwise excludable employees.

Application of Terminated Participants Excludable Employee Category

If the plan being tested for coverage requires employment on the last day of the plan year or a minimum hours of service (such as 1,000 hours) to be benefiting under the plan, a leased employee who terminates employment (or whose services for the recipient are terminated) before the last day of the plan year may be excludable if he or she or she has

[54] IRC §414(n)(2)(B).

500 or fewer hours of service with respect to the recipient for that plan year.[55]

If You're Curious . . .

Contributions or Benefits Provided under Leasing Organization's Plan

Contributions or benefits provided by the leasing organization that are attributable to service performed for the recipient are treated as provided by the recipient.[56] Thus, the recipient may take credit for such contributions or benefits in determining whether a plan directly maintained by the recipient satisfies coverage.

Although the coverage regulations do not address leased employee issues, it should be reasonable to treat the contributions or benefits provided under the leasing organization's plan(s) as if they were provided under a separate plan maintained by the recipient, to the extent such contributions or benefits are attributable to services performed for the recipient. This separate plan would be eligible for permissive aggregation with plans sponsored by the recipient, to pass the ratio percentage test or the nondiscriminatory classification test.[57] Permissive aggregation will be available only if the plan is eligible for aggregation with the plan maintained by the recipient.

Section 6.05: Consequences of Failing Coverage

A plan is disqualified if it fails to satisfy coverage in any plan year. This is because IRC §410(b) is a condition of qualification by reason of IRC §401(a)(3).

Normally when a plan is disqualified, only contributions made during the time for which the plan is not qualified are taxed. IRC §410(b)(4) provides for a special tax rule for HCEs when the reason for disqualification is a failure to satisfy coverage under IRC §410(b) or the minimum participation test under IRC §401(a)(26). Under the special rule, the HCE's entire vested accrued benefit is taxed as if it were distributed in the plan year of disqualification (except to the extent it was taxed in previous years). If the plan year is not the calendar year, taxation occurs for the calendar year in which the plan year ends.

If the only reason for the disqualification is a failure to satisfy IRC §410(b) or IRC §401(a)(26), the trust is treated as qualified in relation to the NHCEs. If there are other reasons for the disqualification, the NHCEs would be subject to the normal tax sanctions applicable to disqualified plans. Under those rules, the NHCEs would be taxed only on the vested portion of contributions allocated or benefits accrued in a nonqualified plan year.

CORRECTING THE FAILURE

A plan may avoid disqualification by correcting the error within the permissible correction period.

Regulatory Correction Period

Treasury Regulation §1.401(a)(4)-11(g)(3) provides that an employer may correct the coverage failure by adopting a **corrective amendment** within 9½ months after the close of the plan year. Because of the regulations section, these corrective amendments are sometimes referred to as "11(g) amendments."

[55] Treas. Reg. §1.410(b)-6(f).
[56] IRC §414(n)(1)(B).
[57] Treas. Reg. §1.410(b)-7(d).

An 11(g) amendment may cure the coverage defects by expanding the group of NHCEs who benefit under the plan (e.g., eliminating an employment classification exclusion) or by increasing the allocations or accruals for NHCEs who already benefit under the plan.[58] An amendment to expand the group of NHCEs who benefit under the plan is usually designed to enable the plan to pass the ratio percentage test, although it might be done to satisfy the nondiscriminatory classification test portion of the average benefit test. An amendment to increase allocations or accruals for the NHCEs would be designed to raise the benefit percentage of the NHCE group under the average benefit test.

In a defined contribution plan, the amendment will require a make-up allocation because amounts already allocated are protected from reduction under the anti-cutback rules of IRC §411(d)(6).

11(g) amendments can vary greatly from plan to plan. For example, if a plan excludes a particular classification of employees (e.g., hourly paid employees), the 11(g) amendment might require contributions to be allocated to selected members of the excluded class. If a plan requires 1,000 hours of service to receive an allocation of employer contributions, the 11(g) amendment might require removal of the service requirement for allocations or reduce the required number of hours for allocation purposes. If a plan requires employment on the last day of the plan year, the 11(g) amendment might remove the last day requirement or it may require that terminated employees who worked more than 500 hours during the plan year be brought into the allocation in reverse order of their termination dates, until the ratio percentage equals at least 70 percent. 11(g) amendments are usually structured to apply only to NHCEs because providing contributions to additional HCEs will not help the IRC §410(b) test results.

If You're Curious . . .

When a 401(k) plan fails coverage, how does the employer retroactively expand coverage? The employee cannot defer compensation on a retroactive basis. The permitted correction method is for the employer to make qualified nonelective contributions (QNECs) for the NHCEs who are added to the 401(k) plan by the corrective amendment. The amendment must be done within 9½ months after the close of the plan year. The qualified nonelective contributions must equal the same percentage of compensation as the average ADP of the NHCEs who were eligible employees for that plan year.[59]

A similar correction rule applies to a 401(m) plan under which the employer makes QNECs for the NHCEs added by the amendment. In this case, the QNECs must equal the same percentage of compensation as the average ACP of the NHCEs who were eligible employees.[60]

The corrective approach described above applies if otherwise ineligible employees are being added to the 401(k) arrangement or 401(m) arrangement. Suppose the arrangement covers enough employees to satisfy the nondiscriminatory classification test, but fails the average benefit percentage test. In that case, the amendment might simply provide for an additional employer contribution to be made to already-eligible employees, so that the average benefit percentage will increase to 70 percent or more.[61] The additional contribution would not have to be a QNEC under these circumstances, because we are not making the affected employees eligible for the 401(k) or 401(m) arrangement on a retroactive basis. Instead, the employer would be increasing the contributions made on their behalf in order to produce a better result under the average benefit percentage test. That contribution could be in the form of a profit sharing contribution, which is subject to a vesting schedule, rather than in the form of QNECs.

[58] Treas. Reg. §1.401(a)(4)-11(g). (Note that these regulations are part of the IRC §401(a)(4) regulations, which deal with corrective amendments to cure violations of the nondiscrimination testing rules, but are made applicable to the correction of coverage violations.)
[59] Treas. Reg. §1.401(a)(4)-11(g)(3)(vii).
[60] Treas. Reg. §1.401(a)(4)-11(g)(3)(vii).
[61] Treas. Reg. §1.410(b)-5.

Treas. Reg. §1.401(a)(4)-11(g)(4) provides that the 11(g) amendment must have substance for the affected employees. If an amendment provides additional contributions or benefits to a nonvested employee who terminated employment on or before the close of the plan year to which the amendment relates, the amendment is disregarded because the employee would not have received any economic benefit from such amendment (that is, the employee will forfeit the benefit being provided through the amendment). Therefore, if benefiting a former employee is critical to curing the coverage violation, and that employee would be zero percent vested in the benefit, the amendment should provide for at least partial vesting on the benefit being provided through the corrective amendment.

Note that this rule does not invalidate an allocation to a nonvested employee who is still employed by the employer as of the last day of the plan year, even if that employee terminates in a subsequent plan year and ends up forfeiting the benefit. This is true even if the employee terminates after the close of the plan year but before the end of the 9½-month correction period prescribed by Treas. Reg. §1.401(a)(4)-11(g).

If a corrective amendment is adopted after the close of the plan year (which is usually the case), the additional allocations or accruals for the preceding year resulting from the corrective amendment:

- must be able to separately satisfy the nondiscrimination testing requirements of IRC §401(a)(4) for the preceding plan year; and
- must benefit a group of employees that separately satisfy the coverage testing requirements IRC §410(b).[62]

In other words, the allocations and accruals already provided under the plan for that year, without regard to the corrective amendment, are disregarded in determining whether the retroactive benefits satisfy these conditions. Because corrective contributions usually are made only on behalf of NHCEs, they generally will satisfy both coverage and nondiscrimination rules.

If You're Curious . . .

If the purpose of the corrective amendment is to satisfy a safe harbor under the IRC §401(a)(4) regulations [i.e., the defined contribution safe harbor under Treas. Reg. §1.401(a)(4)-2(b) or the defined benefit safe harbor under Treas. Reg. §1.401(a)(4)-3(b), including the safe harbors for target benefit plans under Treas. Reg. §1.401(a)(4)-8(b)(3) or for cash balance plans under Treas. Reg. §1.401(a)(4)-8(c)(3)], or to ensure that the plan continues to satisfy such safe harbor, the conditions described above are not applicable to the corrective amendment.

Voluntary Correction under EPCRS when Violation is Not Corrected within Regulatory Period

A coverage violation that is not corrected within the 9½-month regulatory correction period is a demographic failure under the EPCRS (See Chapter 1). The VCP submission procedures under EPCRS must be used for the voluntary correction of demographic failures. SCP is not available for correcting Demographic Failures. If a coverage violation is corrected under VCP, the disqualification consequences described in this section are not applicable.

[62] Treas. Reg. §1.401(a)(4)-11(g)(3)(v)(A).

Section 6.06: Ratio Percentage Test Worksheet

This worksheet may be used to walk an employer through the ratio percentage test for its plan.

		HCE	NHCE	Total
1	Total employees working for the company at any time during the year			
	Excluded employees (count employees in only one category): Less than age _____			
	Less than ______ of service			
	Union			
	Nonresident aliens			
	Total excluded employees			
	Terminated during the year with fewer than 500 hours of service			
2	Total excluded employees			
3	Total nonexcluded employees [(1) – (2)]			
	Employees not benefiting:			
	Fewer than 1,000 hours of service			
	Terminated during the year with 500 or more hours of service			
	Excluded by class			
	Other			
4	Total employees not benefiting			
5	Total employees benefiting [(3) – (4)]			
6	Coverage percentage: [(5)/(3)] (determine for HCEs and NHCEs)			
7	Ratio: [(6) for NHCEs/(6) for HCEs]			
	If (7) > 70%, PASS			

Section 6.07: Review of Key Concepts

- How does a plan satisfy coverage testing under IRC §410(b)?
- What is the ratio percentage test?
- What is the average benefit test?
- Given a set of circumstances, calculate the ratio percentage and indicate whether a plan satisfies the coverage requirements using this test.
- How can a last-day-employed rule affect coverage testing? What other allocation conditions may affect coverage testing?
- Define the term benefiting.
- Determine who is an excludable employee and who is included in the coverage testing group.
- How do special coverage rules, such as mandatory disaggregation, permissive aggregation and elective disaggregation, affect the coverage testing?
- Identify circumstances in which a plan is deemed to satisfy coverage requirements.
- What are the consequences of a failed coverage test?
- How can a plan correct a failed coverage test?

Section 6.08: For Practice – True or False

1. Coverage testing must be performed separately for the 401(k) portion, the 401(m) portion and the 401(a) portion of a plan.
2. A participant who is not benefiting for the profit sharing portion of the plan and who terminates with 500 or fewer hours in the plan year may be excluded from coverage testing.
3. A participant who receives only a forfeiture allocation is treated as benefiting when testing the profit sharing portion of the plan for coverage under IRC §410(b).
4. If an HCE irrevocably waives participation, he or she is excluded from coverage testing under IRC §410(b).
5. A plan that benefits only union employees covered by collective bargaining agreements will automatically satisfy the coverage requirements under IRC §410(b).
6. A plan that benefits only NHCEs will automatically satisfy the coverage requirements under IRC §410(b).
7. A plan must pass the ratio percentage test to retain its qualified plan status under IRC §401(a).
8. Leased employees are considered to be part of the recipient employer's workforce for coverage testing purposes.
9. Employees who are excluded from participating in a plan because they work in Division A, for example, are considered excludable employees when performing the plan's coverage testing under IRC §410(b).
10. An employer maintaining two qualified plans with the same plan year may aggregate the plans for coverage testing under IRC §410(b).

Section 6.09: Sample Test Questions

1. Based on the following information, determine the maximum number of NHCEs who could be excluded from participation and still have the plan satisfy the ratio percentage test of IRC §410(b):
    - X Corporation has 46 employees, of which 45 satisfy the plan's age and service requirements.
    - Out of the 45 participants, five are HCEs who benefit under the plan and 40 are NHCEs who benefit under the plan.
    - The company wishes to exclude a division from participation in the plan. Excluding this division would exclude one HCE.

    A. 1
    B. 10
    C. 17
    D. 22
    E. 23

2. All of the following are excludable employees for coverage testing under IRC §410(b), EXCEPT:

    A. Union employees
    B. Hourly employees
    C. Terminated participants with 500 or fewer hours of service who are not benefiting
    D. Nonresident aliens with no US income
    E. Employees who have not satisfied the plan's age and service requirements

3. Based on the following information, determine the number of employees in the benefiting group for coverage testing under IRC §410(b):
    - The plan is a calendar year profit sharing plan.
    - The profit sharing contribution for the year is $50,000.
    - Participants must be employed on the last day of the plan year to receive an allocation.
    - Participants must work 1,000 hours during the plan year to receive an allocation.

Total nonexcludable employees	100
Nonexcludable active employees working 1,000 or more hours of service	65
Nonexcludable active employees working fewer than 1,000 hours of service	10
Nonexcludable employees who terminated with 500 or more hours of service	20
Nonexcludable employees excluded by class	5

    A. 65
    B. 75
    C. 80
    D. 85
    E. 100

4. All of the following plans satisfy coverage testing under IRC §410(b), EXCEPT:
    A. Plans that benefit all NHCEs and exclude HCEs
    B. Plans that satisfy the ratio percentage test
    C. Plans that benefit only collectively bargained employees
    D. Plans that benefit only HCEs and exclude NHCEs
    E. Plans that benefit 50 percent of the NHCEs and exclude HCEs

5. All of the following statements regarding coverage testing under IRC §410(b) are TRUE, EXCEPT:
    A. In the average benefit test, the plan must satisfy the nondiscriminatory classification test.
    B. A plan that fails coverage testing may be amended within 9½ months after the end of the plan year to comply with IRC §410(b) retroactively.
    C. A plan that includes a fail-safe provision may not be able to satisfy coverage testing using the average benefit test.
    D. In the average benefit test, the plan must satisfy the average benefit percentage test.
    E. In order to pass the ratio percentage test, 70 percent of the nonexcludable employees must be considered benefiting.

6. Which of the following is/are permissible options for correcting a ratio percentage test failure under IRC §410(b)?
    I. Allocate a contribution to vested employees who terminated employment.
    II. Expand the group of HCEs who benefit under the plan.
    III. Expand the group of NHCEs who benefit under the plan.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

7. Based on the following information, determine the ratio percentage under IRC §410(b):
   - The plan is a calendar year plan ending December 31, 2017.
   - Participants must work 1,000 hours during the plan year and be employed on the last day of the plan year to share in the contribution allocation.
   - All employees are listed below and all have satisfied the eligibility requirements of the plan.

Participant	HCE	Hours	Termination Date
A	Yes	2,080	
B	Yes	1,000	5/31/2017
C	No	2,080	
D	No	425	3/15/2017
E	No	1,250	10/1/2017

   A. 33.33%
   B. 40.00%
   C. 50.00%
   D. 66.67%
   E. 100.00%

8. Which of the following conditions placed on plan participants is/are going to negatively impact coverage testing under IRC §410(b)?
   I. Participants must be employed on the last day to receive a profit sharing contribution.
   II. Participants must work at least 1,000 hours during the plan year to receive a profit sharing contribution.
   III. Employees of Division A are not eligible for the plan.

   A. I only
   B. III only
   C. I and II only
   D. II and III only
   E. I, II and III

9. Based on the following information, determine the minimum number of NHCEs that must benefit under the plan to pass the ratio percentage test under IRC §410(b):
   - The plan is a calendar year profit sharing plan.
   - The plan eligibility requirements are age 21 and one year of service.
   - The plan sponsor has two divisions and would like to exclude Division A employees from the plan.

Total nonexcludable HCEs	10
Total benefiting HCEs	9
Total NHCEs	200
Total NHCEs under age 21	15
Total NHCEs that have completed less than 1 year of service	35

   A. 95
   B. 107
   C. 112
   D. 120
   E. 140

10. All of the following statements regarding aggregation and disaggregation for coverage testing under IRC §410(b) are TRUE, EXCEPT:
    A. Permissive aggregation allows the employer to aggregate the plan with another plan and treat the two plans as a single plan for coverage testing purposes.
    B. Plans may not be permissively aggregated unless they are the same type of plan (i.e., both profit sharing plans, both money purchase plans, etc.).
    C. Under certain circumstances, an employer may elect to disaggregate certain groups of employees and perform coverage testing separately for each group.
    D. The benefiting group includes only the employees who benefit under the disaggregated portion of the plan being tested.
    E. Employees who have not satisfied the plan's age and service requirements for the disaggregated portion being testing are excluded.

See next page for answers to the true/false and sample test questions.

Section 6.10: Solutions to True or False Questions

1. True.
2. True.
3. True.
4. False. An irrevocable waiver does not, in itself, make an employee excludable for coverage testing purposes.
5. True.
6. True.
7. False. A qualified plan may satisfy coverage requirements under IRC §410(b) by either the ratio percentage test or the average benefit test.
8. True.
9. False. Do not confuse employees who are excluded from participating with those that are considered excludable for coverage testing. Excludable employees for coverage purposes are those who do not satisfy the age and service requirements for a plan, are terminated with 500 or fewer hours and are not benefiting, are union employees or are nonresident aliens.
10. True.

Section 6.11: Solutions to Sample Test Questions

1. The answer is **C**. The percentage of benefiting HCEs is 80% (4/5). The percentage of benefiting NHCEs must be at least 70% of this number, or 56% of the NHCEs. There are 40 NHCEs and at least 56%, or 23, of them must benefit. Therefore, 17 NHCEs can be excluded and the plan will satisfy coverage testing. To double-check this result, calculate the ratio percentage test as follows:
   HCE = 4/5 = 80.00%
   NHCE = 23/40 = 57.50%
   Ratio Percentage = 57.50%/80.00% = 71.88%
2. The answer is **B**. Hourly employees may be excluded from the plan, but they are not considered excludable employees for coverage testing under IRC §410(b).
3. The answer is **A**. Only the nonexcludable active employees working 1,000 or more hours of service satisfied the allocation requirements and are considered benefiting.
4. The answer is **D**. A plan that excludes all of the employer's NHCEs will not satisfy the minimum coverage requirements.
5. The answer is **E**. In order to pass the ratio percentage test, the percentage of NHCEs who benefit under the plan must be at least 70 percent of the percentage of HCEs that benefit under the plan.
6. The answer is **C**. Expanding the group of HCEs who benefit under the plan will not correct a ratio percentage test failure.
7. The answer is **E**.

A.	Workforce of the employer	5
B.	Ineligible due to age/service	0
C.	Terminated with 500 or fewer hours of service and not benefiting	1 (Participant D)
D.	Coverage testing group	4 (Participants A, B, C and E)
E.	NHCEs in coverage testing group	2 (Participants C and E)
F.	HCEs in coverage testing group	2 (Participants A and B)
G.	Benefiting group	2 (Participants A and C)
H.	NHCEs benefiting	1 (Participant A)
I.	HCEs benefiting	1 (Participant C)
J.	NHCE ratio (H/E)	50.00%

K.	HCE ratio (I/F)	50.00%
L.	Ratio percentage (J/K)	50.00% / 50.00% = 100.00%

8. The answer is **E**. If the plan includes a last day condition or requires 1,000 hours to be eligible for a contribution, it is likely that not all nonexcludable employees will benefit and this affects coverage testing results. In addition, excluding a division of employees from participation also affects coverage testing, often resulting in less than 100 percent coverage of nonexcludable employees.
9. The answer is **A**. The percentage of benefiting HCEs is 90% (9/10). The percentage of benefiting NHCEs must be at least 70% of this number, or 63% of the NHCEs. There are 150 nonexcludable NHCEs (200 – 15 – 35) and at least 63%, or 95, of them must benefit. (150 x 63% = 94.5, rounded up to the next whole number of 95.) To double-check this result, calculate the ratio percentage test as follows:

    HCE = 9/10 = 90.00%
    NHCE = 95/150 = 63.33%
    Ratio Percentage = 63.33%/90.00% = 70.36%
10. The answer is **B**. Plans need not be the same plan type (i.e., both profit sharing plans, both money purchase plans, etc.) in order to use permissive aggregation. However, they must be qualified plans under IRC §401(a) and have the same plan year to use permissive aggregation. An employer may not aggregate a qualified plan with a 403(b) plan or a SEP to demonstrate that the qualified plan passes the coverage test under IRC §410(b).

Chapter 7: Defined Contribution Plans: Contributions and Allocations

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Section 7.01: Key Terms

- Allocation conditions
- Allocation date
- Allocation formula
- Annual additions
- Contribution formula
- Defined contribution dollar limit
- Design-based safe harbor
- Earned income
- Excess amounts
- IRC §401(a)(17) compensation dollar limit
- IRC §414(s) compensation
- IRC §415(c) compensation
- Nondesign-based safe harbor
- Pro rata allocation formula
- Valuation date

Section 7.02: Introduction

A defined contribution plan must state how contributions are determined and how they are allocated among participants' accounts. The **contribution formula** under the plan will identify how the amount that is deposited into the plan is determined. In profit sharing plans, it is not uncommon for the amount of each year's contribution to be up to the discretion of the plan sponsor. However, some profit sharing plans require a definite level of contribution each year, or possibly a floor (such as a base percent of profits) with which the employer must comply.

Certain defined contribution pension plans, such as money purchase plans and target benefit plans, must define the contribution; employer discretion is not permitted. These formulas may be as simple as a percentage of eligible compensation or as complex as an actuarial determxx-heavy rules that were discussed in Chapter 5. Furthermore, the chapter will discuss what definitions of compensation may be used for allocation purposes.

Once the amount of contribution is determined, another formula, called the **allocation formula**, will specify how the money is to be allocated to the participants' accounts. In some cases, the contribution formula and the allocation formula are the same: for example, an employer may decide to contribute 5 percent of compensation of the eligible participants and to allocate that contribution by giving each participant's account 5 percent of that participant's compensation. On other occasions, the allocation formula is very different.

This chapter will concentrate on how the contribution is allocated once it is made. Limitations on those allocations will be discussed, as well as a reference to the top-heavy rules that were discussed in Chapter 5. Furthermore, the chapter will discuss what definitions of compensation may be used for allocation purposes.

Section 7.03: Allocation of Contributions

WHEN CONTRIBUTIONS ARE ALLOCATED

The employer may make contributions during the plan year or wait until after the close of the plan year to make its contributions. The plan must define when allocations will be made to participants' accounts—that is, when the allocation dates are. The allocation date may affect the manner in which investment gains and losses are allocated to the accounts.

Before we discuss actual allocation timing, it is important that we clarify some terminology. Some administrators think of (or plans define) allocation dates as dates when the plan's investments are revalued. Others think of or define valuation dates as dates when contributions are allocated. The terminology a person or plan is using is not important. It is important to understand the relevant concepts and how they affect participants' benefits in a defined contribution plan.

In this section, we focus on when contributions are properly allocated to a participant's account. Until a contribution is allocable to a participant's account in accordance with the terms of the plan, such amount should not be reflected in or posted to that participant's account. We will call the date on which contributions are allocated the **allocation date**. We

will call the date on which earnings are allocated to a participant's account the **valuation date**.

Allocations of Employer Contributions in Defined Contribution Plans

The employer's contribution to a defined contribution plan is typically allocated to participants' accounts once per year, usually as of the last day of the plan year. This is particularly true with employer contributions to a profit sharing plan, money purchase plan, target benefit plan, stock bonus plan and the employer nonelective contributions to a 401(k) plan. In many cases, the employer makes its contribution for the plan year after the close of the year. In other words, the contribution is made after the allocation date and then allocated as of that date to accounts based on the allocation formula outlined by the plan.

If the employer makes its contribution during the plan year, but the allocation date is not until a later date (e.g., the last day of the plan year), the contribution will not be immediately allocated to the participants' accounts. Until the allocation date, each participant's share of the contribution cannot be determined because of factors that are not known until the allocation date actually occurs. For example, a plan typically allocates the employer's contribution wholly or partly on the basis of each participant's compensation for the plan year. Final compensation amounts are not known until the allocation date. Similarly, the plan might require that a certain number of hours of service be completed or that the participant be employed on the allocation date for an allocation to be made to the participant's account.

A plan may provide for the allocation of employer contributions on more than one date in the plan year. A profit sharing plan could provide for a discretionary contribution to be made by the employer on a quarterly basis, with contributions made for a quarterly allocation period to be allocated only to those participants who satisfy the allocation conditions for that quarter. A money purchase plan could provide for an employer contribution equal to a percentage of compensation for each week of service, and provide for the allocation of such contributions as of the last day of each month. In designing allocation conditions, care should be taken to coordinate with these multiple allocation dates. For example, if an employer contribution is allocated for each quarter, it would be cumbersome administratively, and may cause over contribution problems, if a participant is required to be employed on the last day of the plan year to receive allocations for the first three quarterly allocation periods.

Allocation of Elective Contributions under 401(k) Arrangements

Because elective contributions under a 401(k) arrangement are made at the participant's election, special contribution and allocation requirements apply. The amount of the participant's elective contribution is usually deducted from the participant's paycheck under a payroll withholding election. The Department of Labor (DOL) requires transmission of these deducted amounts to the plan as soon as possible after the amount is withheld.[1] The DOL has issued regulations establishing a safe harbor for the timely deposit of employee contributions to small retirement plans. Under the safe harbor, participant contributions to a pension or welfare benefit plan with fewer than 100 participants at the beginning of the plan year will be treated as complying with the regulations if the contributions are deposited no later than the 7th business day following the day on which the amounts would have been payable to the participant in cash.[2] As elective contributions come into the trust, the administrator will allocate the contributions to the accounts of the respective participants who elected to have those deferrals made on their behalf.

Allocation of Matching Contributions

Because matching contributions are made with respect to elective contributions (or, in some cases, after-tax employee contributions), the plan may provide that matching contributions are also allocated more frequently than once per year. For example, a plan may provide for the allocation of matching contributions to participants' accounts as of the last day of each month or on a payroll by payroll basis, based on the participants' elective contributions for the monthly allocation period. However, many plans provide for a once-per-year allocation of matching contributions, particularly if the

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[1] DOL Reg. §2510.3-102.

[2] DOL Reg. §2510.3-102 (a)(2).

rate of matching contributions is determined each year by the employer or if the employer typically does not fund the matching contribution until after the close of the plan year.

As with allocations of other employer contributions, the allocation of matching contributions more frequently than once per year should be coordinated with the conditions established by the plan for receiving such allocations. For example, if an employee is required to be employed on the last day of the plan year, but the plan allocates matching contributions on a quarterly basis, then matching contributions made to the employee's account during the plan year are not properly allocable if the employee terminates before the end of the year. The employer might want to consider providing for the allocation of matching contributions only as of the last day of the plan year in this scenario. Alternatively, the employer might consider requiring employment on the last day of each quarter as a condition of receiving allocations of matching contributions in that quarter.

If You're Curious . . .

Employer Contributions Made before the Allocation Date

If employer contributions are made before they become allocable to plan participants, the trustee has a fiduciary obligation to invest the contributed funds before they are allocated to participants' accounts. Many small employers would like to prefund the employer contribution for the owners of the business who are participants in the plan, but wait until after the close of the plan year to do the same for other participants. Is this permissible? The short answer is no. This approach would constitute discriminatory operation of the plan, and probably also would contradict the terms of the plan.

A profit sharing plan must provide a definite allocation formula. This includes not only a specific formula for how the employer's contribution will be allocated, but specific rules for determining whether a participant is entitled to an allocation. When a contribution is made during the plan year that is intended to be allocated for that plan year (rather than as a contribution for a prior year), the allocation of that contribution cannot occur until the data required to apply the plan's allocation formula and to evaluate the allocation conditions are available. Furthermore, the plan may not allocate the contribution as of a date that is contrary to the terms of the plan.

One way to address this situation is to avoid early contributions and allocations and fund the plan on or after the allocation date. On the other hand, if prefunded contributions and interim allocations are desired, there are two primary ways to do so.

Approach 1: Treat Prefunded Amount as General Investment

One way is to prefund all or part of the employer's anticipated contribution, but not allocate it to any particular participants' account balances. Instead, the prefunded amount is invested in a general trust account until it can be allocated as of the end of the plan year, in accordance with the terms of the plan.

Approach 2: Adopt Multiple Allocation Dates

The plan could be amended to modify its allocation procedures by adopting multiple allocation dates for employer contributions (e.g., as of the last day of each quarter), so that the eligible participants would receive allocations to their respective accounts as of each allocation date. Note that the allocation date provision of the plan is a benefit, right or feature that must be nondiscriminatory.[3]

[3] Treas. Reg. §1.401(a)(4)-4.

CONDITIONS ON RECEIVING ALLOCATIONS

Not all participants in a defined contribution plan will necessarily receive an allocation of employer contributions. The plan may impose certain conditions a participant must satisfy to share in the allocation for a plan year. These conditions are known as accrual requirements or **allocation conditions** because they determine whether the participant accrues a benefit (i.e., receives an allocation to his or her account) for the plan year.

In Chapter 3, we discussed eligibility requirements under the plan. These requirements determine the applicable entry date when the employee is first considered a participant in the plan. Once someone becomes a participant in a defined contribution plan, he or she must satisfy the allocation conditions for that year to accrue benefits for that year, even though he or she already met the initial eligibility requirements.

In other words, the eligibility rules set the conditions to become a participant. The allocation conditions in the plan set annual requirements that an otherwise eligible participant must satisfy to receive an allocation of employer contributions for a particular plan year.

There are no specific statutory rules that address accrual requirements in a defined contribution plan. The accrual rules in IRC §411(b), including the year of participation definition in IRC §411(b)(4), apply only to defined benefit plans. The DOL recognized that the absence of accrual requirements for defined contribution plans enables such plans to impose reasonable allocation conditions, such as an hours requirement and/or a last day requirement. In regulations, the DOL has acknowledged that DC plans may limit allocations to those who have fewer than 1,000 hours of service or who are not employed at year end.[4]

Hours-of-Service Condition

A common accrual requirement in a defined contribution plan is that the participant must satisfy a minimum hours-of-service requirement for the plan year. This minimum requirement may not exceed 1,000 hours. This service requirement is separate from the eligibility service requirement. The eligibility service requirement is a condition to become a participant in the plan. The accrual service requirement is a condition to share in the contribution allocation after the employee becomes a participant and is a recurring (i.e., annual) requirement that applies every plan year. An employee will not necessarily earn 1,000 hours of service in every plan year just because he or she completed 1,000 hours in a particular year to satisfy a one-year-of-service eligibility condition to become a participant in the first place.

A typical full-time employee will have no problem satisfying the 1,000-hour requirement, unless the employee is employed for less than six months of the year (a 40-hour-per-week schedule results in 1,000 hours in 25 weeks and 2,080 hours in a 52-week year). However, an employee who works part-time, works on a seasonal basis, takes a leave of absence for a portion of a year or has an erratic work schedule, might not satisfy the 1,000-hour requirement in a particular plan year.

EXAMPLE 7-1. Erratic Work Schedule. Krista is a part-time employee of a corporation that maintains a money purchase plan. The plan requires employees to complete one year of service in an eligibility computation period to be eligible to participate. The plan also requires that participants complete 1,000 hours in a plan year to share in the allocation of that year's contribution. Although Krista's normal work schedule is 15 hours of service per week, she often works a different number of hours. Krista satisfied initial eligibility requirements on September 18, 2016, because that was the end of the first eligibility computation period in which she earned at least 1,000 hours. She became a participant January 1, 2017. However, because of her erratic work schedule, there are some plan years in which Krista is credited with 1,000 hours of service or more and some years with fewer than 1,000 hours. For those plan years in which Krista is credited with at least 1,000 hours, she will share in the allocation of employer contributions. In the other plan years, she will not.

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[4] DOL Reg. §2530.200b-1(b).

To determine whether a participant satisfies the hours-of-service allocation condition, all hours for the plan year must be taken into account, even if the employee was an eligible participant for only part of the year. This issue may arise in the first plan year in which the employee qualifies as a participant, if the employee's plan entry date is not the first day of the plan year. The issue may also arise when an employee is ineligible to participate for part of the plan year because of an eligibility exclusion related to employment classification.

EXAMPLE 7-2. Hours Completed Before Mid-Year Entry Date. A profit sharing plan has a plan year ending December 31 and provides for semiannual entry dates (January 1 and July 1). An employee becomes a participant on the plan entry date that follows completion of a year of service.

Loren's entry date is July 1, 2018. To share in an allocation of the employer's contribution for a plan year, a participant is required to complete at least 1,000 hours of service for the plan year. The employer makes a discretionary contribution for 2018. To determine whether Loren satisfies the 1,000-hour allocation condition for that plan year, all of his hours in 2018 are taken into account (i.e., hours credited from January 1 through December 31), even though Loren is an eligible participant only from July 1 through December 31.

If the plan were to credit only his hours during his period of participation, Loren would have only 900 hours. However, because the entire year's hours must be counted, Loren satisfies the 1,000-hour allocation condition and is eligible for an allocation of the employer's contribution made for the plan year. Loren's share of the contribution will be determined in accordance with the plan's allocation formula.

EXAMPLE 7-3. Union Exclusion. A plan excludes union employees from participating. Pauline's union status terminates on October 1, 2017. She becomes immediately eligible for her employer's nonunion profit sharing plan because as of October 1, 2017, she has satisfied the plan's eligibility requirements, and has long passed the entry date that otherwise would have applied to her had the plan not contained a union exclusion. The plan year ends December 31, 2017.

To receive an allocation of employer contributions, the plan requires that a participant complete at least 1,000 hours of service during the plan year. For the 2017 calendar plan year, Pauline's hours of service while she was a union employee from January 1 through September 30 (as well as the hours credited after she ceased to be covered by the union) are counted toward determining whether she satisfies the 1,000-hour allocation condition.

If You're Curious . . .

Post-Termination Payments Result in Hours of Service Credits

Suppose a participant terminates employment before the last day of the plan year, but receives compensation after that date (for example, payment for unused vacation). Generally, the payment of compensation after termination results in hours of service being credited for such compensation. Hours of service are credited for periods in which an employee is paid for the nonperformance of services.[5]

EXAMPLE 7-4. Cashout of Unused Vacation Time. Dean terminates employment on June 20. His employer's money purchase plan has a plan year that ends December 31. As of his termination date, Dean has earned 950 hours of service for the plan year. The plan requires 1,000 hours of service as a condition for receiving allocations of employer contributions.

[5] DOL Reg. §2530.200b-2.

In his final paycheck, Dean is paid for two weeks of unused vacation. Based on his weekly hours, the two weeks of vacation result in 80 hours of additional service credit. With the paid vacation, Dean has satisfied the 1,000-hour requirement for the plan year. Thus, he will share in an allocation of his employer's money purchase contributions for that year, unless there are other allocation conditions that prevent him from qualifying for an allocation.

EXAMPLE 7-5. Severance Payments. Marion terminates employment on January 31. Her employer's profit sharing plan has a plan year that ends September 30. Marion has earned 400 hours for the plan year in which her termination date falls (determined as of her termination date). The company provides Marion a severance pay package that continues monthly payments to her for the rest of the calendar year in which she is terminated. The severance payments result in hours of service credits for Marion for February through December following her January 31 termination.

For the plan year ending September 30 following her January 31 termination date, the hours credited to Marion for her severance payments made from February through September result in Marion having at least 1,000 hours of service for such plan year. Marion will share in the allocation of profit sharing contributions for the plan year in which her January 31 termination occurs, unless there are other allocation conditions that prevent her from qualifying for an allocation.

Although Marion might be entitled to an allocation, the amount of that allocation may be based on her compensation exclusive of the severance payments, depending on how the plan defines compensation for allocation purposes. Some plans exclude severance payments specifically. Other plans exclude categories of compensation (such as welfare benefits) that might encompass the severance payments. [Note that, as of July 1, 2007, the IRS does not recognize true severance payments (i.e., amounts paid to the participant that would not be paid but for the participant's termination of employment) as eligible compensation for §415 purposes. Therefore, any definition that uses 415 compensation as its basis, such as the definition of HCE, top-heavy compensation, compensation for elective contributions and the safe harbor definitions of compensation for allocation purposes, must exclude true severance payments.][6]

Short Plan Year

If there is a short plan year, is the hours requirement automatically prorated? Because an hours requirement for allocation purposes is a plan design issue, and is not required by statute or regulation to be in the plan, there is no legal rule that demands proration of the hours requirement. Thus, the plan document should specify whether a lesser hours requirement applies in the event of a short plan year. If the short plan year is created by a plan amendment that changes the plan year, that amendment could specify a proration requirement. If the first plan year under a new plan is a short plan year, because the effective date of the plan is less than 12 months before the end of the first plan year, the plan document may specify that, for the first plan year, a lesser hours requirement applies.

Last-Day Employment Condition (i.e., Last-Day Rule)

Another common allocation condition under a defined contribution plan is to require the employee to be employed with the employer on the last day of the plan year (for example, on December 31 in a calendar year plan). A variation of this rule is to require employment on a specific allocation date, if employer contributions are allocated more than

[6] Treas. Reg. §§1.401(k)-1(e)(8); 1.415(c)-2(e)(3).

once per plan year (for example, quarterly allocation dates). The employer should make sure a participant's termination date is properly documented, particularly when it is close to the end of the plan year, to support the plan's denial of an allocation of employer contributions to the participant's account for the year of termination. The last-day employment condition may be required in addition to a minimum hours-of-service requirement, or it may be required instead of an hours-of-service condition.

EXAMPLE 7-6. Employment Terminates After Employee Has Completed 1,000 Hours for Plan Year. Luis is a participant in a profit sharing plan. Luis quits in the 11th month of the plan year and does not return before the end of the plan year. He is credited with 1,600 hours of service for the plan year. The plan states that a participant's account shares in the allocation of employer contributions only if the participant is employed on the last day of the plan year. This is in addition to a 1,000-hours-of-service condition.

Luis' account does not share in the allocation for the current plan year because he is not employed on the last day of the plan year, even though he has satisfied the plan's eligibility requirements and was credited for at least 1,000 hours of service for the plan year. The same result would apply if Luis were fired or laid off, unless the plan provides different rules depending on the reason for the termination.

EXAMPLE 7-7. Employed on Last Day of Plan Year But Hours for Plan Year are Less Than 1,000. A money purchase plan provides that a participant's account shares in the allocation of employer contributions if the participant is employed on the last day of the plan year and is credited with at least 1,000 hours of service for the plan year. Ashleigh has satisfied the plan's eligibility requirements and she is employed on the last day of the plan year. However, she is credited with only 600 hours of service for the current plan year. Consequently, her account does not share in the allocation of employer contributions made for that plan year.

EXAMPLE 7-8. Plan Requires Last-Day Employment But Not Hours Requirement. Suppose that the plan in the prior **EXAMPLE 7-7** provides an allocation to the participant's account if the participant is employed on the last day of the plan year, regardless of the number of hours of service credited for the plan year. Ashleigh's account would share in the allocation of employer contributions under these facts.

If You're Curious . . .

Plan Years Ending on Holiday or Weekend/Employee Absent on Last Day

The last-day employment condition is satisfied if the employee is still considered to be an employee of the employer as of the last day of the plan year. It is not relevant whether the last day of the plan year is actually a work day (e.g., a holiday or weekend) or whether the employee shows up for work that day (e.g., takes a vacation day or sick day).

Effect of FMLA Leave

The Family and Medical Leave Act of 1993 (FMLA)[7] requires employers to provide employees up to 12 weeks of annual leave for certain family and medical purposes. The leave does not have to be paid. Employers with at least 50 employees are subject to this rule.[8] FMLA §104 requires that, upon return from FMLA leave, an employee's rights with respect to employment benefits must be restored.

[7] P.L. 103-3.
[8] FMLA §101(4).

Employment benefits include benefits under pension and other retirement plans. If the plan requires employment on a specific date to obtain benefits (e.g., last-day rule), an employee on FMLA leave on that date is deemed to have been employed on that date.[9] However, the employee is not required to be given credited service for such unpaid leave period toward benefit accrual. For example, if a plan requires 1,000 hours to receive an allocation of contribution or an accrual of benefits in a defined benefit plan, FMLA leave hours will not be considered for this purpose. On the other hand, if the leave is paid, the employee would get credit for hours.

Post-Termination Payments

Suppose a participant terminates employment before the last day of the plan year, but receives compensation after that date (for example, payment for unused vacation). Generally, the payment of compensation after termination does not change the individual's termination date for purposes of determining whether he or she is employed on the last day of the plan year, even if hours of service are credited for such compensation. Sometimes, the circumstances of payment may indicate that the employment relationship has not actually terminated, particularly if ongoing payments are made after the employee's termination. The plan administrator may need to make the ultimate determination of whether a termination of employment has occurred.

EXAMPLE 7-9. Post-Termination Payment of Accrued Vacation. Madhu terminates employment on June 20. His employer's profit sharing plan has a plan year that ends June 30. The plan requires employment on the last day of the plan year as a condition for receiving allocations of employer contributions. In his final paycheck, Madhu is paid for two weeks of unused vacation.

For purposes of determining hours of service, Madhu receives credit for the hours of service attributable to the paid vacation time. However, Madhu is still treated as not employed on the last day of the plan year (that is, the June 30 following his June 20 termination date), even though two weeks of vacation, if measured from June 20, would have extended beyond June 30.

EXAMPLE 7-10. Vacation Taken Before Termination Date. Let's change the facts of the prior example. Suppose Madhu takes his two weeks of vacation starting June 20, and then terminates employment at the end of that two-week vacation. In that case, his employment relationship with the employer is not terminated until July 4 (i.e., two weeks after June 20), which is after the June 30 plan year end, so he would satisfy the allocation conditions for such plan year.

What if Employee is Not Part of Eligible Class on Last Day of Plan Year?

The last-day rule looks only to whether the employee is employed on the particular date, not whether he or she is included in an eligible class of participants for that date. The fact the employee is not in an eligible class of participants on the last day of the plan year might affect the amount of employer contributions allocated to the participant for the plan year (for example, the plan may include only compensation paid for the portion of the plan year during which the employee is an eligible participant), but it does not mean the employee is considered to have terminated before the end of the plan year.

EXAMPLE 7-11. Employee Not a Member of the Eligible Group at Year End. A company has two divisions of employees: Division A and Division B. The company's profit sharing plan excludes employees in Division B. The plan requires employment with the company on December

[9] DOL Reg. §825.215(d)(4).

31 (i.e., the last day of the plan year) to share in an allocation of employer contributions for that year.

Ling works in Division A and is an eligible participant in the profit sharing plan. On November 1, Ling is transferred to Division B. As of December 31, she is no longer an eligible participant because of the Division B employment exclusion in the plan. Nonetheless, Ling is entitled to an allocation for the plan year ending on the December 31 following her November 1 transfer. The last-day rule does not deny her an allocation merely because she is in an ineligible classification on that date, because she is still employed with the company on December 31.

However, if the plan allocates contributions on the basis of a participant's compensation earned while he or she is eligible for the plan, then Ling's share of the profit sharing contribution for the plan year in which her November 1 transfer to Division B occurs will be based only on her compensation from January 1 through October 31, when she was working in Division A.

The plan could specify other allocation conditions besides the last-day rule. In the above **EXAMPLE 7-11**, if the plan provided that a participant is not eligible for an allocation unless he or she is part of an eligible classification of employees as of the last day of the plan year, then Ling would be denied an allocation for the plan year in which she was transferred to Division B.

Leased Employees

There are no regulations under IRC §414(n) to guide us on how to apply a last-day rule to a leased employee. A reasonable rule is that if, as of the last day of the plan year, the leased employee is still contracted to provide services to the recipient, pursuant to an agreement with the leasing organization, the leased employee satisfies the last-day rule with respect to the recipient's plan, even if services are not actually being performed on that date. (This assumes, of course, that the leased employees are not excluded from the plan by classification.) An issue arises, however, when the leased employee's services for the recipient employer are terminated before the end of the plan year, but the leased employee continues to work for the leasing organization (i.e., is reassigned to an unrelated recipient). It would seem reasonable to treat this individual as having terminated from employment with respect to the recipient's plan, since no services are being performed for the recipient any longer. This is analogous to a common law employee of the recipient whose employment with the recipient terminates during the year, but who goes to work immediately for another employer that is unrelated to the recipient.

EXAMPLE 7-12. Leased Employee. Jean is a leased employee with respect to Corporation X. Her common law employer is StaffCo, a leasing organization. Corporation X maintains a profit sharing plan that does not exclude leased employees. Jean is eligible to participate in Corporation X's plan. The plan year ends December 31 and the plan requires employment on December 31 of a plan year to share in the allocation of employer contributions for that plan year.

On October 31, StaffCo terminates its service contract with Corporation X and Jean is reassigned to Corporation Y, a company that is not related to Corporation X under IRC §414(b), (c) or (m). It should be reasonable for Corporation X to treat Jean as failing to satisfy the last-day rule for that plan year and deny her an allocation of employer contributions.

Sometimes an employer hires a leased employee as its own employee. In the year that the individual switches status from leased employee to an employee, the switch is not a termination of employment. If the individual is employed as an employee as of the end of the plan year, the individual satisfies the last-day condition and shares in the allocation. In **EXAMPLE 7-12**, if Jean becomes an employee of Corporation X as of October 31, and is still working for Corporation X as of December 31, she satis-

fies the last-day requirement and shares in the allocation for that plan year.

Sometimes an employer enters into an arrangement with a leasing organization under which some or all of the employer's employees are terminated by the employer and rehired by the leasing organization. The leasing organization then leases the employees back to the recipient. These leased-back employees are now categorized as leased employees under IRC §414(n). Similar to the issue raised in **EXAMPLE 7-12** above, the switch from employee status to leased employee status is not a termination of employment. The last day employment condition is satisfied in the year of the switch if, as of the last day of the plan year, the former employee is a leased employee of the recipient. In EX**AMPLE 7-12** above, if Jean was an employee through October 31, and then became a leased employee as of October 31, and she is still providing services for Corporation X as a leased employee as of December 31, she would satisfy the last-day rule and share in the allocation for that plan year.

Other Allocation Conditions

Other accrual requirements may relate to certain events or to a participant's employment classification.

Death, Disability, and Retirement

Some plans provide that, if a participant dies or becomes disabled during the plan year, the participant is excused from certain allocation conditions, such as the hours requirement or the last-day requirement. The participant could be exempt from one or both of such requirements. The plan could provide this exception just for death, just for disability or for either occurrence.

Another common exception is for a participant who has reached the normal retirement age (NRA) stated in the plan and retires before the end of the plan year. Again, it is common to see such a participant excused from the hours condition and/or the last-day rule.

Exceptions to the allocation conditions on account of death, disability or retirement are optional. Plans are not required to allow for such exceptions. If the exceptions are desired, the plan document must expressly provide for such exception in order for the participant to be excused from an allocation condition on account of death, disability or retirement.

Employment Classification

The plan may provide for separately determined allocations based on job category (such as salaried and hourly employees), job location (such as divisions or office locations), organizational structure (such as subsidiaries of a controlled group) or compensation category (such as highly compensated and nonhighly compensated). For example, the plan might provide that different allocation conditions apply to salaried employees than to hourly employees or that a certain portion of the contribution is allocable only to employees in a particular division.

Conditions on Elective Contributions

Employer-provided benefits, other than matching contributions, cannot be conditioned on whether the employee makes elective contributions under the 401(k) arrangement.[10] This prohibition applies to the allocation of employer contributions to a profit sharing plan, money purchase plan, stock bonus plan or target benefit plan. For example, the plan may not provide that a participant will fail to share in the allocation of employer contributions under a money purchase plan merely because he or she elects not to make elective contributions under the employer's 401(k) plan. Even under the 401(k) plan, allocation of employer nonelective contributions for a plan year cannot be conditioned upon whether the participant has made elective contributions for that year. Only matching contributions under the 401(k) plan may be conditioned on the basis of elective contributions.

[10] IRC §401(k)(4)(A).

EXAMPLE 7-13. No Elective Contributions Made During the Plan Year. Chad is a participant in his employer's 401(k) plan. The plan provides for matching contributions and nonelective contributions. The matching contribution is 50 percent of the first 6 percent of compensation deferred under the 401(k) arrangement. Nonelective contributions are allocated to participants who have completed at least 1,000 hours of service during the plan year and are employed on the last day of the plan year (December 31).

For the current plan year, Chad elects not to make elective contributions, but is employed on the last day of the plan year, and is credited with 1,500 hours for such year. The employer makes a nonelective contribution for the plan year. Chad is eligible to share in the allocation of the nonelective contribution, even though he did not make elective contributions for such year. Of course, he will not receive any allocation of matching contributions for that year.

Additional accrual requirements usually will not apply to a participant's right to make elective contributions under a 401(k) plan. When the employee becomes eligible to participate, he or she may execute a salary reduction agreement and begin deferring compensation to the plan. Whether the employee is employed at the end of the plan year, or is credited with a minimum number of hours of service for the plan year, will not affect his or her right to make elective contributions for that year if he or she has already satisfied the plan's eligibility requirements.

EXAMPLE 7-14. Effect of Termination of Employment on Pre-Termination Elective Contributions. Deion is a participant in a 401(k) plan. He has elected to have $100 per month withheld from his paycheck as an elective contribution under the plan. Deion terminates employment before the end of the plan year. His termination does not affect the allocation of his elective contributions withheld for the plan year, even though the plan might require that he be employed on the last day of the plan year to share in the allocation of employer nonelective contributions or even employer matching contributions.

EXAMPLE 7-15. Effect of Reduction in Hours on Eligibility to Make Elective Contributions. A 401(k) plan provides for a six-month eligibility requirement. To share in the allocation of employer nonelective contributions made for a plan year, a participant is required to complete at least 1,000 hours of service in that plan year. This hours requirement applies only to the allocation of nonelective contributions, not to the right to make elective contributions.

Dru commences employment on March 1 and becomes eligible for the 401(k) plan on the following September 1. Dru completes only 850 hours of service from her employment date of March 1 through the end of the plan year (December 31). Although she is not eligible for an allocation of employer nonelective contributions for the plan year in which she becomes a participant due to the 1,000-hour allocation condition, she is eligible to make elective contributions for the period September 1 (her plan entry date) through December 31.

Allocation Conditions on Matching Contributions

A plan may provide for accrual requirements, such as an hours-of-service requirement or a last-day rule, as a condition for receiving matching contributions. As noted earlier, the employer should coordinate any accrual requirements for the allocation of matching contributions with the desired allocation dates for matching contributions. If matching contributions are allocated monthly, but a participant must be employed on the last day of the plan year to be entitled to an allocation of matching contributions, the plan may encounter administrative problems relating to matching contributions allocated prior to the participant's termination date.

Safe Harbor 401(k) Plans Are Allowed Only Limited Allocation Conditions

A 401(k) plan is exempt from the ADP nondiscrimination test if the employer provides a safe harbor matching contribution or a safe harbor nonelective contribution.[11] All employees who are eligible to defer under the safe harbor 401(k) arrangement for the plan year must be eligible for the safe harbor contribution, with some limited exceptions. The IRS provides that allocation conditions, such as the last-day rule or the 1,000-hour rule, may not be applied to the safe harbor contribution.

Coverage Testing May Be Affected

Note that using allocation conditions might affect the plan's ability to satisfy the coverage requirements under IRC §410(b).

If You're Curious . . .

Standardized Pre-Approved Plan

Standardized pre-approved plans may not use a 1,000-hour requirement for allocation purposes and are allowed only limited use of the last-day-of-employment rule. In fact, these plans may not require an eligible employee to satisfy any minimum hours requirement in order to receive an allocation, unless the employee has a termination of employment before the end of the plan year. In the event of a termination of employment before the close of the plan year, the standardized plan may require up to 501 hours of service as an allocation condition.[12]

This requirement for standardized plans relates to the coverage rules. A standardized plan must be designed so that it is impossible to fail coverage. These limitations on the accrual requirements in a standardized plan enable the plan to satisfy the coverage requirement because participants who would fail to receive an allocation of employer contributions by reason of these limited accrual requirements would be treated as excludable employees (i.e., disregarded) for coverage testing purposes.[13]

Top-Heavy Rules May Require an Allocation

If the plan is top-heavy (within the meaning of IRC §416), a minimum allocation may have to accrue to the participant, even though the participant does not satisfy the plan's normal allocation conditions. For example, in a top-heavy defined contribution plan, an eligible employee who is employed on the last day of the plan year must receive the top-heavy minimum contribution, regardless of his or her hours of service for the plan year, even though the plan requires a minimum number of hours for the plan year to share in the regular allocation of employer contributions.[14]

Returning from Certain Military Service Periods

An individual who is rehired by the employer (or returns from a leave of absence) after a period of qualified military service may be entitled to accrue benefits for the absence period, even though the allocation conditions prescribed by the plan were not satisfied for such period.[15]

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[11] IRC §401(k)(12).
[12] Rev. Proc. 2000-20, section 4.12.
[13] Treas. Reg. §1.410(b)-6(f).
[14] Treas. Reg. §1.416-1, M-10.
[15] IRC §414(u).

If You're Curious . . .

Allocation Requirements in Plan Year in which Plan Terminates

When a plan is terminated, a termination date is established [usually by board resolution, subject to notice requirements for pension plans under ERISA §204(h)]. The termination date does not automatically end the plan year. The plan year cycle continues as before the plan termination, until the plan's assets are fully distributed, unless the plan year is amended. So, a short plan year is not created as of the termination date. When the assets are fully distributed, the last plan year ends on the date of the final distribution for Form 5500 reporting purposes. But that final year in many cases occurs after the plan year in which the termination date falls.

If there is an allocation of employer contributions for the plan year in which the termination occurs, how should the allocation conditions be applied? Generally, the conditions will work the same as for any other 12-month plan year. However, the plan may need to be amended or appropriate language included in the resolution to terminate the plan to clarify who is eligible for the final allocation. The resolution of these issues is partly affected by whether the plan is a pension plan or a nonpension plan.

Section 7.04: Nondiscrimination in Contribution Allocations

IRC §401(a)(4) requires that a qualified plan provide for nondiscriminatory contributions or benefits. Some contribution formulas or allocation formulas result in participants receiving different rates of contribution (expressed as a percentage of compensation). These differences might cause the plan to fail the nondiscrimination requirements.

Generally, formulas that allocate contributions in proportion to compensation or that take into account the effect of Social Security payments by the employer (i.e., permitted disparity formulas) will satisfy the nondiscrimination requirements under safe harbor standards provided in Treasury Regulations. If the safe harbor standards are not satisfied, the allocation must pass an objective numerical test called the general test to demonstrate that the allocation of contributions is not discriminatory.

Some defined contribution plans, such as target benefit plans, plans with age-weighted allocations or plans with different contribution/allocation formulas for different participant groups, will satisfy the nondiscrimination general test by looking at the projected retirement benefit generated by the contribution, rather than the contribution itself. This type of general testing is known as cross-testing because it tests a defined contribution plan allocation on the basis of the benefit it will provide at retirement. In other words, it looks at a defined contribution plan as if it were a defined benefit plan (thereby crossing over plan types). A plan that has different allocation formulas for different employee groups is commonly called a tiered allocation or new comparability plan.

The elective contributions under a 401(k) arrangement, and matching contributions, are subject to special nondiscrimination tests, known as the actual deferral percentage (ADP)[16] and actual contribution percentage (ACP)[17] tests.

DISCONTINUANCE OF CONTRIBUTIONS AT RETIREMENT AGE; OTHER AGE DISCRIMINATION ISSUES

A defined contribution plan cannot prevent a participant from receiving an allocation solely because he or she has reached a certain age, *including normal retirement age* (NRA).[18] For example, if a participant has reached NRA, but continues to satisfy the plan's accrual requirements each plan year, he or she must share in the allocation of employer

[16] IRC §401(k)(3).
[17] IRC §401(m)(2).
[18] IRC §411(b)(2).

contributions for that plan year. Similarly, the participant must be able to continue making elective contributions under the 401(k) arrangement. Special rules may apply to determine employer contributions to a target benefit plan after the participant reaches NRA.[19] These special rules recognize that the target benefit formula states a benefit payable at NRA and the participant has reached that age.

SAFE HARBOR DEFINED CONTRIBUTION PLANS

From a plan administration standpoint, the least burdensome way to satisfy the nondiscrimination rules of IRC §401(a)(4) is to use a safe harbor approach. A safe harbor plan may be design-based or nondesign-based.[20] A **design-based safe harbor** means the plan is designed to satisfy IRC §401(a)(4) because of the method used to allocate employer contributions. A **nondesign-based safe harbor** means the plan is eligible for a shortcut testing method because it is designed in a manner that is less likely to be discriminatory than more aggressive plan designs. Using a safe harbor plan design will be less costly to administer but may be more costly to the employer in terms of the level of contributions provided to its employees.

Do not confuse the safe harbor plans described in this section with safe harbor 401(k) plans described in IRC §§401(k)(12) and 401(k)(13). The term "safe harbor" is used throughout the IRC to describe conditions that eliminate or reduce a taxpayer's liability under the law. With regard to retirement plans, meeting "safe harbor" requirements frequently grants nondiscriminatory status to a particular plan provision, thus eliminating the need for additional testing.

Design-Based Safe Harbor Defined Contribution Plans

A design-based safe harbor plan is deemed to provide nondiscriminatory contributions because the allocation formula is designed to produce uniform allocation rates (or rates that are deemed to be uniform).

Uniform Allocation Required

A cornerstone of the design-based safe harbor plan is that the method of allocating the employer contributions must be one that provides a uniform allocation, either as a percentage of compensation or a dollar amount.[21] The same allocation formula generally must apply to all employees.

Where uniformity is satisfied as a percentage of compensation, the plan must allocate employer contributions solely on the basis of plan year compensation, and the plan must define compensation for allocation purposes in a nondiscriminatory manner. [IRC §414(s) outlines the requirements that must be met for a compensation definition to be nondiscriminatory. Nondiscriminatory compensation is often referred to as IRC §414(s) compensation.]

The Treasury Regulations define plan year compensation to mean IRC §414(s) compensation for the entire plan year or for any specified 12-month period ending in the plan year.[22] A compensation period of less than the entire plan year may be used to determine plan year compensation if the employee is a participant for only part of the plan year (e.g., initial entry on a date other than the first day of the plan year). In that case, plan year compensation may be defined as compensation for only the portion of the plan year in which the employee is a participant.

EXAMPLE 7-16. Plan Uses IRC §414(s) Compensation for Allocation Purposes. Maggie is a participant in a profit sharing plan. The plan allocates the employer's contribution in proportion to the participants' IRC §414(s) compensation for the plan year. The plan year is a calendar year. For each plan year, Maggie's IRC §414(s) compensation for the entire plan year is used to determine her allocation of employer contributions and forfeitures. The plan makes allocations using a definition of compensation that satisfies the definition of plan year compensation for safe harbor purposes.

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[19] IRC §411(b)(2)(B).

[20] The IRS uses this terminology in its determination letter procedures.

[21] Treas. Reg. §1.401(a)(4)-2(b)(2).

[22] Treas. Reg. §1.401(a)(4)-12.

EXAMPLE 7-17. Plan Defines Compensation for Allocation Purposes to Include Only Period of Eligibility. Cliff becomes a participant in the profit sharing plan on July 1 of the current plan year. The plan year ends December 31. Cliff's IRC §414(s) compensation for the period July 1 through December 31 is used to determine his allocation of employer contributions and forfeitures for the plan year, because he was only eligible for the plan for that portion of the plan year. This is a permissible definition of plan year compensation. Alternatively, the plan may be written so that Cliff's compensation for the entire plan year is taken into account, even though he is a participant for only part of the year.

EXAMPLE 7-18. Noncalendar Year Plan Uses Calendar Year Period to Measure Compensation. The plan year for a profit sharing plan ends June 30. A participant's allocation each June 30 is based on his or her IRC §414(s) compensation for the calendar year that ends on the preceding December 31 (e.g., compensation for the calendar year ending December 31, 2015, is used for the allocation for the plan year ending June 30, 2016). This is a permissible definition of plan year compensation for safe harbor purposes because it is determining compensation for a 12-month period that ends in the plan year.

If You're Curious…

If a 12-month period other than the plan year is used, as in **EXAMPLE 7-18**, a special rule applies to new employees who are hired less than 12 months before the end of the 12-month compensation period.[23] Under this special rule, the employee's plan year compensation must be measured for the plan year or for the period of participation during that plan year.

EXAMPLE 7-19. Compensation for Mid-Year Entrant When Compensation is Not Measured on a Plan Year Basis. Assume the plan year ends September 30, 2018, and the compensation measuring period is the calendar year ending in the plan year (2017 in this case). Drew was hired on March 1, 2017, and became a participant in the plan on April 1, 2018 (i.e., the mid-year entry date).

Normally, to determine Drew's allocation, the plan would look to his compensation for calendar year 2017. Because he was hired less than 12 months before December 31, 2017 (i.e., the end of the compensation period), his compensation must be determined:

- For the plan year (October 1, 2017, through September 30, 2018); or
- For the portion of the plan year he is a participant (April 1, 2018, through September 30, 2018).

For subsequent plan years, the plan may use his compensation for the calendar year ending in the plan year to determine his plan year compensation.

Pro rata allocation formula. A plan will satisfy the uniformity requirement if the employer contribution is allocated under a pro rata formula based on plan year compensation. Under the **pro rata allocation formula**, each participant's share of the employer contribution is equal to the participant's share of the total plan year compensation of all participants. The uniformity requirement is satisfied because each participant's allocation represents the same percentage of plan year compensation.

If the plan is a profit sharing plan or stock bonus plan, for which the employer's contribution is discretionary, the allocation percentage may change from year to year, but the pro rata formula will guarantee that the percentage in a particular plan year will be the same for all participants. The same result is achieved under a plan that has a fixed contribution that

[23] See paragraph (5) of the plan year compensation definition in Treas. Reg. 1.401(a)(4)-12.

is expressed as a uniform percentage of plan year compensation, and each participant's allocation equals the contribution so determined. A money purchase plan typically uses this design to satisfy the safe harbor.

EXAMPLE 7-20. Pro Rata Allocation Method. A profit sharing plan uses the pro rata method to allocate employer contributions. The employer contributes under a discretionary contribution formula.

- The plan year is the calendar year.
- Compensation for allocation purposes is IRC §414(s) compensation, measured for the plan year.
- For the plan year, there are two participants.
- The employer contributes $10,000 to the plan.

The allocation is as follows:

Employee	IRC §414(s) Compensation	Allocation	Percentage of IRC §414(s) Compensation
Mason	$80,000	$8,000	10%
Brad	$20,000	$2,000	10%
Totals	$100,000	$10,000	10%

The total IRC §414(s) compensation of all participants is $100,000. Mason's share of that total compensation is $80,000, or 80 percent. Therefore, Mason is allocated 80 percent of the contribution or $8,000. Brad's allocation is 20 percent. Each participant's allocation is the same percentage (10 percent) of his plan year compensation. This will always be the case under the pro rata allocation method. Therefore, the allocation method satisfies the nondiscrimination requirement by design.

EXAMPLE 7-21. Mid-Year Entrant. Assume in the prior **EXAMPLE 7-20** that Brad was not an eligible participant for the entire plan year, but became a participant on the July 1 entry date for the plan year, which is the mid-year entry date. The plan defines compensation for the plan year to include only compensation paid while an eligible participant.

Brad's compensation for the period July 1 through December 31 is $11,000. This is his plan year compensation for allocation purposes. Therefore, the plan would allocate the employer contribution by taking into account only $11,000, rather than $20,000, of Brad's compensation. The employer contribution of $10,000 is allocated on the basis of $91,000 of total compensation. Mason's share of the allocation is 80/91 and Brad's share is 11/91.

Employee	IRC §414(s) Compensation	Allocation	Percentage of IRC §414(s) Compensation
Mason	$80,000	$8,791	10.99%
Brad	$11,000	$1,209	10.99%
Totals	$91,000	$10,000	10.99%

If Brad's allocation were expressed as a percentage of his IRC §414(s) compensation for the entire plan year it would equal $1,209/$20,000, or only 6.05 percent. Because the plan limits plan year compensation to compensation paid for the period of eligibility, the percentage is based on compensation for that period only to determine whether the allocation rate is uniform for safe harbor purposes. Therefore, Brad's allocation percentage is deemed to be the same as Mason's allocation percentage—10.99 percent. By taking into account only compensation for the period of eligibility, the plan has shifted part of the allocation to Mason that otherwise would have been allocated to Brad, but the plan still satisfies the design-based safe harbor.

EXAMPLE 7-22. Money Purchase Plan. The contribution formula under a money purchase plan is 5 percent of plan year compensation. The allocation for each participant is the contribution determined under the contribution formula. The compensation definition satisfies IRC §414(s). The plan is a design-based safe harbor because the allocation for each participant is a uniform percentage (5 percent) of plan year compensation. This is true even if the 5 percent contribution is design-based-only compensation for the portion of the plan year that the employee is an eligible participant, as illustrated in **EXAMPLE 7-21** above.

Permitted disparity formula under IRC §401(l). Permitted disparity is a means of weighting the contribution in favor of people who earn in excess of the taxable wage base so that their entire retirement benefit—from both the employer and Social Security—is uniform for all employees as a percentage of compensation. If a permitted disparity formula is used to allocate the employer contribution, the allocation is deemed to satisfy the uniformity requirement, even though the actual allocation percentages are greater for HCEs.[24] Permitted disparity is not available to ESOPs.[25] A more detailed discussion of the permitted disparity rules is found in *The ASPPA Defined Contribution Plan Series Volume 2: 401(k) Plans and Intermediate Administration Topics*, available through the ASPPA bookstore at ecommerce.asppa-net.org.

Uniform dollar amount. A design-based safe harbor plan may satisfy the uniformity requirement by allocating the same dollar amount to each participant. The plan also may allocate the same dollar amount per unit of service (not exceeding one week) performed by the participant during the plan year.[26] These types of formulas tend to favor NHCEs and so are included in the safe harbor category.

EXAMPLE 7-23. Annual Contribution Divided Equally Among Eligible Participants. A profit sharing plan allocates an equal portion of the employer contribution to each eligible participant's account. For the plan year, there are ten eligible participants, and the employer's contribution is $10,000. The allocation for each participant is $10,000/10, or $1,000. The plan is a design-based safe harbor because each participant's allocation, expressed as a dollar amount, is equal. This is not a commonly used allocation formula.

EXAMPLE 7-24. Dollar Amount Contribution Per Hour of Service. A money purchase plan provides for an employer contribution equal to $2.00 for every hour of service credited for the plan year. Kendra is credited with 1,500 hours of service for the plan year and receives an employer allocation of $3,000. The same contribution allocation is made for all eligible participants with the same number of hours of service for the plan year. The plan is a design-based safe harbor.

EXAMPLE 7-25. Dollar Amount Contribution Per Month of Service. Suppose in the prior **EXAMPLE 7-24** that the formula is $200 for each month of service credited for the plan year. The plan is not a design-based safe harbor because the unit of time used to compute the dollar amount allocation exceeds one week.

Compensation for Design-Based Safe Harbor Plans

The manner in which the design-based safe harbor plan defines compensation for allocation purposes will determine whether the compensation definition must be tested for nondiscrimination purposes each year. IRC §414(s) outlines the requirements that must be met for a compensation definition to be nondiscriminatory.

IRC §414(s) compensation may be defined under a safe harbor definition or a modified definition. If a safe harbor defi-

[24] Treas. Reg. §1.401(a)(4)-2(b)(2)(ii).
[25] Treas. Reg. §1.401(l)-1(a)(4)(ii).
[26] Treas. Reg. §1.401(a)(4)-2(b)(2)(I).

nition is used (e.g., IRC §415 compensation), then the allocation will always be a uniform percentage of IRC §414(s) compensation, and the plan may rely on the design-based safe harbor without having to test its definition of compensation. If a modified definition is used (e.g., exclusion of bonuses, overtime and/or commissions), the compensation is not treated as IRC §414(s) compensation unless it satisfies the compensation ratio test.

Under the compensation ratio test, a ratio is determined for each participant. The numerator is the compensation being used for the participant under the plan definition, and the denominator is the participant's IRC §415 compensation. Average compensation ratios are then determined separately for the HCEs and for the NHCEs. The average compensation ratio for the HCEs cannot exceed that of the NHCEs by more than a de minimis amount.[27] Whether a difference is de minimis depends on the facts and circumstances. Expect the IRS to view the de minimis standard very narrowly. Some IRS personnel have indicated that they will use a 3 percent or narrower spread as a de minimis standard, but emphasize that no particular percentage is considered by the IRS as a safe harbor.

The compensation ratio test must be performed on an annual basis when a modified compensation definition is used for allocation purposes, but the plan is demonstrating that it satisfies the nondiscrimination test based on the design-based safe harbor rule. Changes in demographics or compensation practices may affect whether the compensation ratio test is satisfied in a particular year. The fact that the plan uses a modified definition does not mean it fails to be a design-based safe harbor plan under IRC §401(a)(4); it simply means the plan's compensation definition must be tested each year to see if it satisfies IRC §414(s). The plan is a safe harbor plan only in those years in which the compensation taken into account under the plan satisfies IRC §414(s).

If there is some question as to whether a modified definition of IRC §414(s) compensation is nondiscriminatory, a determination letter may be requested from the IRS to determine whether IRC §414(s) is satisfied.

If You're Curious . . .

EXAMPLE 7-26. Plan Definition of Compensation and Safe Harbor Allocation Uniformity. A profit sharing plan allocates employer contributions and forfeitures under a pro rata formula based on plan compensation. Plan compensation is defined as compensation for the entire plan year (or the portion of the plan year in which the employee is participant), taking into account all compensation for services except bonuses and commissions.

Let's assume that the plan administrator determines that the plan compensation definition satisfies the compensation ratio test for the plan year and, thus, may be treated as an IRC §414(s) compensation definition. The plan satisfies the design-based safe harbor because the allocation is a uniform percentage of plan compensation, and plan compensation satisfies the requirements of IRC §414(s).

Assume the allocation for the plan year equals 5 percent of plan compensation. The allocation is made to 125 eligible participants. Two of the eligible participants in the plan are Jalisa and Beverly. The following chart shows these two employees' total compensation, plan compensation and allocation amount.

Employee	Total Compensation	Plan Compensation	Allocation	Percent of Total Compensation	Percent of Plan Compensation
Jalisa	$50,000	$40,000	$2,000	4%	5%
Beverly	$40,000	$40,000	$2,000	5%	5%

Jalisa has bonuses and commissions totaling $10,000, so her plan compensation is less than her actual total compensation. If each participant's allocation were expressed as a percentage of total compensation, Jalisa and Beverly's allocations would not be uniform.

However, because the plan administrator has determined that the plan's definition of compen-

[27] Treas. Reg. §1.414(s)-1(d)(3)(v).

sation satisfies IRC §414(s) by passing the compensation ratio test, plan compensation may be used to determine if the allocation is uniform for nondiscrimination testing purposes. Therefore, the uniform allocation requirement is satisfied because the allocation rate is a uniform percentage of plan compensation. The percentages for Jalisa and Beverly, as well as the percentages for all other participants, are equal when expressed as a percentage of plan compensation. The plan is a design-based safe harbor for the plan year.

Note that passing the IRC §414(s) compensation ratio test for the current plan year does not guarantee that the test will be passed in future years, because compensation practices may change. The administrator will have to test the compensation definition each year to determine if the plan satisfies the safe harbor test for that year.

What if a modified definition of compensation fails to satisfy the compensation ratio test for a particular plan year? It depends. An isolated failure of the compensation ratio test due to an extraordinary unforeseeable event causing unusual compensation amounts will be disregarded (and the compensation will be considered nondiscriminatory) if prior years' ratio tests were passed. If it is not an isolated failure due to an extraordinary unforeseeable event, the employer has two choices. The first choice is to amend the definition of compensation to satisfy IRC §414(s), and continue to rely on the design-based safe harbor rule. For the year in which the failure occurs, this may require the employer's having to make additional contributions for certain participants to cure the IRC §401(a)(4) failure. The second option is to allocate the contribution under the plan's definition of compensation and satisfy IRC §401(a)(4) under general testing (i.e., not using a safe harbor design).

Allocation of Forfeitures under Safe Harbor Defined Contribution Plans

A safe harbor plan, whether design-based or nondesign-based, must allocate forfeitures in the same manner as it allocates employer contributions (other than forfeitures used to pay plan expenses[28]). It does not matter whether the forfeitures are used to reduce the employer's contribution or are allocated as additional employer contributions.

If the plan includes matching contributions [e.g., a 401(k) plan provides for a 50 percent match on elective contributions up to 6 percent of compensation], the plan may treat forfeitures (or a specified portion of forfeitures) as matching contributions. Forfeitures treated in this manner might be used to reduce the employer's matching contribution obligation or to increase the rate of match for the plan year. Any forfeitures treated as matching contributions are tested for nondiscrimination under the ACP test and not under the general test of IRC §401(a)(4).

If You're Curious . . .

Certain Plan Provisions Will Not Affect Reliance on IRC §401(a)(4) Safe Harbors

There are certain provisions in the plan that will not affect reliance on the IRC §401(a)(4) safe harbors, even though the provisions might cause a participant's allocation not to be uniform.[29] Any such provisions must be applied uniformly to all employees.

Entry Dates

A safe harbor plan may have multiple entry dates. If a participant enters the plan on an entry date other than the first day of the plan year, his or her compensation measurement period for that plan

[28] Rev. Rul. 84-156, 1984-2 C.B. 97.
[29] Treas. Reg. §1.401(a)(4)-2(b)(4).

year may be based solely on the period of participation, resulting in a lesser allocation to the participant. The use of nonuniform entry dates does not cause the plan to fail to be a safe harbor.[30]

Certain Conditions on Allocations

A participant's right to share in the allocation may be conditioned on employment on the last day of the plan year and/or completion of a minimum number of hours of service (not exceeding 1,000 hours). Such conditions are commonly found in defined contribution plans. The plan may include an exception from these conditions if the participant terminates employment for one or more of the following reasons: retirement, disability, death or military service. The fact that some participants do not get an allocation because of the last-day rule or an hours-of-service rule, or the fact that an exception for death or disability results in nonuniform application of these conditions, does not cause the plan to fail the safe harbor test.[31]

Limits on allocations. A participant's allocation may be limited to a specified dollar amount or percentage of plan year compensation without violating the safe harbor.[32] The IRC §415 rules are examples of such limits, but the plan also may impose lesser limits. For example, the plan may provide that a participant's allocation cannot exceed $10,000. The allocation is still treated as uniform even though the allocation percentage for a participant who reaches the $10,000 limit is less than the allocation percentage for participants not affected by the $10,000 limit. A safe harbor plan also may limit the dollar amount of plan year compensation taken into account. IRC §401(a)(17) sets a mandatory limit on compensation, but the plan also may provide for a lesser dollar limit.

Lower allocations for HCEs. Any plan provision that results in a lower allocation for one or more HCEs does not affect the plan's status as a safe harbor plan, even though such provision does not apply uniformly to all employees.[33]

Multiple formulas. The trickiest exception rule is the one for multiple formulas. This rule applies to any plan that allocates employer contributions and forfeitures under two or more formulas, including a top-heavy contribution formula. If the conditions of this rule are not satisfied, the plan is not a safe harbor and must apply general testing.

Basic requirements. A participant's allocation must be the greater of the allocations determined under the formulas, or the sum of the allocations determined under the formulas.[34] In addition, each formula, if it were tested separately, must satisfy either the design-based safe harbor or the nondesign-based safe harbor.[35] Any formula that is available only to NHCEs is deemed to satisfy the safe harbor requirement.[36]

EXAMPLE 7-27. Multiple Formulas. A profit sharing plan allocates employer contributions and forfeitures under two separate formulas. First, an equal dollar amount is allocated among the participants, up to $500. Any amounts remaining after the initial allocation are allocated pro rata on the basis of plan year compensation. Compensation is defined under a safe harbor definition of IRC §414(s) compensation. A participant's allocation is the sum of the allocations under the two formulas. The plan is a design-based safe harbor even though it contains multiple formulas. The first formula provides a uniform dollar amount allocation and the second formula provides a uniform percentage of plan year compensation.

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[30] Treas. Reg. §1.401(a)(4)-2(b)(4)(ii).
[31] Treas. Reg. §1.401(a)(4)-2(b)(4)(iii).
[32] Treas. Reg. §1.401(a)(4)-2(b)(4)(iv).
[33] Treas. Reg. §1.401(a)(4)-2(b)(4)(v).
[34] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(A).
[35] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(C).
[36] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(C), last sentence.

Availability of formulas must be uniform. All formulas must be available on the same terms to all employees.[37] For example, if there is a last-day employment condition on one formula, that condition also must apply to all other formulas. Similarly, if there is an hours-of-service condition (e.g., 1,000 hours) under any formula, the same service condition must apply to all the formulas. Formulas are not available on the same terms if one formula is for all participants, and a second formula is only for participants in a certain job category (e.g., salaried employees). There are, of course, some exceptions to this availability rule.

A formula that is available only to NHCEs does not violate the uniformly available rule provided that the allocation conditions under that formula are the same as all the other formulas.[38]

EXAMPLE 7-28. Multiple Formulas Apply to NHCEs Only. Assume the profit sharing plan in **EXAMPLE 7-27** makes the $500 allocation only to NHCEs, but all participants may share in the pro rata allocation based on plan year compensation. The multiple formulas do not fail to satisfy the safe harbor rule merely because one formula is available only to the NHCEs.

EXAMPLE 7-29. Different Requirements for Multiple Formulas. Suppose the pro rata allocation based on plan year compensation is conditioned upon employment on the last day of the plan year, but that condition does not apply to the $500 allocation. The exception to the uniform availability rule is not satisfied, and the plan cannot rely on the safe harbor rule.

Qualified nonelective contributions (QNECs) under IRC §§401(k) or 401(m) arrangements. A 401(k) arrangement may permit the employer to make QNECs to satisfy the ADP test and/or ACP test. QNECs are usually available only to NHCEs (or a specified group of NHCEs). Although QNECs are included in the ADP test or ACP test, QNECs also must satisfy IRC §401(a)(4) because they are nonelective employer contributions. In fact, the plan must be able to satisfy IRC §401(a)(4) when QNECs are combined with other nonelective contributions, and also when the other nonelective contributions are tested separately from the QNECs.[39]

EXAMPLE 7-30. NHCE-Only QNEC Plus Permitted Disparity Formula. A 401(k) plan allocates QNECs only to NHCEs. The plan allocates employer contributions that are not designated as QNECs, as well as forfeitures, under a permitted disparity formula under IRC §401(l). The permitted disparity formula is available to both HCEs and NHCEs. For the plan year, the QNEC equals 2.25 percent of each NHCE's plan year compensation. The permitted disparity allocation for each participant is 7 percent of total compensation plus 5.7 percent of excess compensation. An NHCE's allocation is the sum of the allocations under both formulas.

When the QNECs and other nonelective employer contributions are tested on a combined basis, the plan is a safe harbor only if it can satisfy the rule for multiple formulas. In this example, the multiple formula rule is satisfied because each formula would independently satisfy the design-based safe harbor, and the formulas are available on a uniform basis except for the fact that QNECs are available only to NHCEs.

EXAMPLE 7-31. Compensation Limited for QNEC Allocation. Assume in the prior **EXAMPLE 7-30** that the QNECs are made only to NHCEs whose plan year compensation is less than

[37] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(1).

[38] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(2).

[39] Treas. Reg. §1.401(a)(4)-1(b)(2), §1.401(k)-1(b)(5) and §1.401(m)-1(b)(5); Treas. Reg. §1.401(k)-2(a)(6)(ii) and §1.401(m)-2(a)(6)(iii) (December 29, 2004), for plan years beginning on or after January 1, 2006.

$20,000. Although the QNECs are not available to all NHCEs on a uniform basis, they are available only to NHCEs and the multiple formula rule is still satisfied.

EXAMPLE 7-32. Last-Day Employment Rule for One Formula. Assume the same facts as in **EXAMPLE 7-30** above, except a last-day employment condition applies only to the permitted disparity formula, and not to the QNECs. In this case, the QNECs are not available to the NHCEs on the same terms as the permitted disparity formula and the exception is not available. The plan does not satisfy the multiple formula rule. The allocations made under both formulas must be combined and tested under general testing. Note that the general testing method should be easily satisfied because the QNECs are allocated only to NHCEs and are, therefore, deemed to be nondiscriminatory.

Safe harbor 401(k) plans. Regular nonelective contributions under a safe harbor 401(k) plan might not satisfy the IRC §401(a)(4) safe harbors even if the safe harbor nonelective contribution described in IRC §401(k)(12)(C) is made solely for NHCEs. This is because the allocation conditions for the two types of nonelective contributions might be different.

Top-heavy formulas qualify for exception from uniformity requirement under certain circumstances. If one of the formulas is a top-heavy formula, it does not fail to be uniform merely because the top-heavy allocation is available only to non-key employees (even if some of the non-key employees are HCEs), or only when the plan is top-heavy. The top-heavy formula must be available on the same terms as the other formulas. The allocation conditions under Treas. Reg. §1.416-1, M-10 may be applied to the top-heavy formula, without violating the same terms requirement, even though the same allocation conditions are not applied to the regular formula.[40]

For this exception to apply, the plan must be able to pass coverage under IRC §410(b) by treating an employee as not benefiting if his or her allocation is determined solely with reference to the top-heavy formula.[41] This is a troublesome requirement and is likely to result in compliance problems for certain plans.

EXAMPLE 7-33. Plan Would Pass Ratio Percentage Test If Non-key Employees Who Receive Only Top-Heavy Were Treated as Not Benefiting. A participant's allocation under a defined contribution plan is the greater of two amounts:

- The allocation determined under a pro rata formula based on plan year compensation; or
- The top-heavy minimum allocation.

The pro rata formula is available only to participants who are employed on the last day of the plan year and are credited with at least 1,000 hours of service. The top-heavy minimum allocation is available only to non-key employees employed on the last day of the plan year. The 1,000-hour condition is not applied to the top-heavy formula because such a condition would violate Treas. Reg. §1.416-1, M-10. The formulas do not fail to be uniform merely because the top-heavy formula is available only to non-key employees and the 1,000-hour requirement is applied only to the pro rata allocation formula.

For the plan year, there are three HCEs and ten NHCEs. There are no excludable employees for coverage testing. During the plan year, two of the NHCEs fail to complete at least 1,000 hours of service. Both of these NHCEs are non-key employees and receive the 3 percent top-heavy minimum contribution. The other employees receive an allocation under the pro rata formula equal

[40] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(3).
[41] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(3).

to 8.5 percent of plan year compensation.

	1,000+ Hours	> 1,000 Hours	Regular Contribution	Top-heavy Contribution	Total
HCEs	3	0	3	0	3
NHCEs	8	2	8	2	10

If the two NHCEs who received only the top-heavy contribution were treated as not benefiting, the plan would pass coverage because 80 percent of the NHCEs (8/10) would be benefiting for coverage purposes. Therefore, the plan does not fail to be a safe harbor plan merely because of the separate top-heavy formula.

EXAMPLE 7-34. Plan Would Fail Ratio Percentage Test If Non-Key Employees Who Receive Only Top-Heavy Minimum Were Treate as Not Benefiting. Assume in the prior EXAMPLE 7-33 that four NHCEs (rather than only two NHCEs) fail to complete at least 1,000 hours of service and receive only the top-heavy allocation. Although these employees are actually benefiting for coverage purposes, the plan must be able to pass coverage without them to satisfy the safe harbor rule under IRC §401(a)(4).

If the four NHCEs were treated as not benefiting, only 60 percent of the NHCEs would be benefiting for the plan year. Because 100 percent of the HCEs are benefiting, the plan would fail to satisfy the ratio percentage test. Unless the plan can pass the average benefit test (by assuming the four NHCEs who received only the top-heavy contribution have a zero percent allocation), the plan will not satisfy this exception for multiple formulas. In that case, the plan may not rely on the safe harbor test under IRC §401(a)(4), and the plan will have to use the general test to determine whether it satisfies the nondiscrimination rules of IRC §401(a)(4).

We emphasize that this rule is applied solely for purposes of determining whether the existence of the separate top-heavy allocation formula causes the plan to fail to be a safe harbor plan under IRC §401(a)(4). For actual coverage testing, an employee is treated as benefiting, even if his or her only allocation is due to the application of the top-heavy rules.

Separate contribution/allocation formulas for different related employers maintaining a single plan. If a plan is maintained by more than one related employer [i.e., controlled group of businesses under IRC §414(b) or (c), or an affiliated service group under IRC §414(m)], the plan might provide for separate contribution and/or allocation formulas for the participants employed by each participating employer. Such a plan would fail to be a safe harbor because the multiple formulas do not apply uniformly to all participants.

EXAMPLE 7-35. Dual Allocation Formulas. Corporation X and Corporation Y constitute a controlled group of corporations, as described in IRC §414(b). Corporations X and Y jointly maintain a defined contribution plan. The employees of Corporation X receive a uniform allocation of 8 percent of plan year compensation, but the employees of Corporation Y receive a uniform allocation of 5 percent of plan year compensation. The plan is not a design-based safe harbor under IRC §401(a)(4) because there are two allocation formulas, and they are not available uniformly to all employees. The plan will have to use the general test to determine whether it satisfies the nondiscrimination rules of IRC §401(a)(4).

Section 7.05: IRC §415 Limitations

A defined contribution plan must limit the annual additions that are allocated to a participant's account for a limitation year. The "limitation year" can be defined by the plan as any 12-month period. Usually, the limitation year is defined as the plan year. If the limitation year is not the same as the plan year, there is typically an administrative reason for the difference. For example, an employer might have a uniform limitation year for multiple plans where the plans do not all have the same limitation year. Also, some employers maintain the limitation year on a period that matches the employer's taxable year, even though the plan year is different with respect to the general administrative operation of the plan. This section will discuss how the IRC §415 annual addition limitations work.

DESCRIPTION OF THE LIMITATION

The annual additions that are credited to the participant's account for the limitation year are limited to the lesser of:

1. 100 percent of the participant's IRC §415 compensation; or
2. The defined contribution dollar limit in effect for that year.

Annual Additions

The IRC §415 limitations are applied to the annual additions allocated to the participant's account for the limitation year. **Annual additions** are:

- Employer contributions [including elective deferrals under a 401(k) plan, matching contributions and nonelective contributions];
- Forfeitures allocated to the participant's account; and
- Employee contributions (i.e., after-tax employee contributions).[42]

Catch-up contributions are not included in annual additions. Investment earnings also are not included in annual additions.

Certain Additions Disregarded

Certain additions to a participant's account are disregarded for purposes of the IRC §415 limits.

Cash-out repayments and restorative allocations. Amounts paid by the employer to restore a participant's forfeiture pursuant to the cash-out/repayment restoration rules are not annual additions.[43] Similarly, amounts repaid by the participant as a condition for receiving the restoration of the forfeited benefit are not annual additions.[44] These amounts represent previously accrued benefits that were subject to the IRC §415 limits in prior years when the allocations were originally made.

Rollovers and transfers. Direct transfers from one plan to another are not annual additions.[45] Rollovers (including direct rollovers) are not annual additions.[46]

On occasion, surplus assets from a terminated defined benefit plan are transferred into a defined contribution plan, where the surplus is allocated as additional contributions. In that situation, the allocations of the surplus assets to participants' accounts are annual additions. If the surplus is held in a suspense account for a period during which it is being reallocated, the surplus is considered to be an annual addition only at the time that it is actually allocated.[47]

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[42] IRC §415(c)(2).
[43] Treas. Reg. §1.415(c)-1(b)(ii)(A).
[44] *Id.*
[45] Treas. Reg. §1.415(c)-1(b)(1)(iii).
[46] Treas. Reg. §1.415(c)-1(b)(3)(i).
[47] IRC §4980(d)(2)(C)(iii).

Loan repayments. Loan repayments are not annual additions.[48] The amount borrowed was part of the employee's account balance that had already been tested under the IRC §415 limits. The repayments are simply restoring those amounts to the account.

Special Rules for Certain Elective Deferrals and Matching Contributions

Elective deferrals made by HCEs that are refunded to correct violations of the ADP nondiscrimination test under IRC §401(k)(3) are still annual additions for the limitation year in which they were allocated unless they are recharacterized as catch-up contributions. Similarly, after-tax employee contributions and matching contributions are still annual additions for the year allocated, even if they are distributed to HCEs to correct violations of the ACP nondiscrimination test under IRC §401(m).[49]

Designated Roth contributions are annual additions, because they are treated in the same manner as other elective deferrals.

If elective contributions (including designated Roth contributions) exceed the IRC §402(g) limitation ($18,500 for 2018), and the excess is distributed by the April 15 deadline, these excess deferrals are not annual additions.[50]

Summary of Amounts Included as Annual Additions

Below is a summary of the amounts that are included as annual additions under IRC §415.

Source	Annual Addition?
Employer nonelective contributions	Yes
Employer matching contributions	Yes
QNECs	Yes
QMACs	Yes
Pre-tax elective contributions	Yes
Designated Roth contributions	Yes
Forfeiture allocations	Yes
After-tax employee contributions	Yes
Catch-up contributions	No
Investment earnings	No
Rollover contributions	No
Direct transfers	No
Loan repayments	No
Refunded elective contributions due to failure of ADP test	Yes, unless recharacterized as catch-up
Distributed after-tax employee contributions or matching contributions due to failure of ACP test	Yes
IRC §402(g) excess distributed by 4/15	No

When Annual Additions Are Credited

As a general rule, employer contributions are credited as annual additions in the limitation year if, under the terms of the plan, the contributions are allocated to the participant's account as of a date in that limitation year. If the employer

[48] Treas. Reg. §1.415(c)-6(b)(3)(ii).
[49] Treas. Reg. §1.415(c)-6(b)(1)(ii).
[50] Treas. Reg. §1.415(c)-6(b)(2)(ii)(D).

contributions credited for a limitation year are made after the end of the year, the contributions are not treated as annual additions for that prior year unless they are actually made no later than 30 days after the period during which the contribution was deductible—that is, the due date (including extensions) for the filing of the federal income tax return for the employer's tax year in which the limitation year ends.[51] Employer contributions that are allocated for a prior limitation year, but are made after that deadline, are treated as annual additions for the year in which they are contributed.

If You're Curious . . .

There are two exceptions to this timing rule. First, make-up contributions made by the employer to correct an erroneous failure to an allocation are considered to be annual additions for the year to which they relate.[52] The portion of the make-up contribution that represents the actual investment gains of the trust is not treated as an annual addition for any year, because this is intended to make up for earnings, which would not have been treated as annual additions had the allocation been made in a prior year.

If an employer makes a contribution to satisfy a funding deficiency under a money purchase plan or target benefit plan, the contribution is an annual addition for the prior limitation year when the contribution was required to be made.[53] The contribution must be allocated to those participants who should have received the allocation had the contribution been made timely. An amount added to the contribution to reflect a reasonable amount of interest is not an annual addition. If the employer receives a funding waiver under a money purchase plan or a target benefit plan, the employer will be required to satisfy the funding waiver using an amortization schedule.[54] The portion of the amortized contribution that would be required in a prior limitation year is treated as an annual addition for that prior year. Any reasonable amount of interest that is paid under the amortization schedule is not an annual addition.[55]

EXAMPLE 7-36. Annual Additions. Janice is a participant in her employer's 401(k) plan. During the plan year, the following adjustments were made to her account for the December 31, 2017 plan year:

- Elective deferrals of $18,000 were contributed.
- Catch-up contributions of $5,000 were contributed.
- An employer matching contribution of $2,500 was deposited.
- An employer nonelective contribution allocation of $750 was allocated to the account.
- Investment earnings of $3,000 were reflected.
- Because Janice was an HCE and the ADP testing was failed, $1,000 of the elective deferrals were reclassified to be catch-up contributions, and $4,000 of elective deferrals were refunded on February 15, 2017.
- Janice borrowed $20,000 from the plan, and made one repayment of $133.33 of interest and $272.19 of principal.

What were her annual additions?

Annual additions do not include catch-up contributions, earnings or loan repayments. Janice had $6,000 of catch-up contributions as of the end of the plan year (determined by taking into account the amount that was reclassified due to the failed nondiscrimination testing). The balance of her elective deferrals, $17,000, are annual additions, even though $4,000 of that amount was ultimately refunded to her in 2018.

[51] Treas. Reg. §1.415(c)-6(b)(6)(i)(B).
[52] Treas. Reg. §1.415(c)-6(b)(6(ii)(A).
[53] Treas. Reg. §1.415(c)-6(b)(6)(ii)(B)(i).
[54] Rev. Rul. 78-223, 1978-1 C.B. 125.
[55] Treas. Reg. §1.415(c)-6(b)(6)(ii)(B)(3).

In addition to the $17,000 of elective deferrals, her annual additions also include the matching contributions ($2,500), and the profit sharing contribution ($750). Her total annual additions for 2017 were, therefore, $20,250.

Indexed Dollar Limit

The **defined contribution dollar limit** under IRC §415(c)(1)(A) is $55,000 for 2018. It is subject to indexing for cost-of-living adjustments (COLA), as provided in IRC §415(d). The indexing is limited to multiples of $1,000. The COLA is effective for plan years ending in the calendar year in which the indexed amount applies.[56] For example, a June plan year end will apply the $55,000 limit for the year that begins July 1, 2017 and ends June 30, 2018.

If a short limitation year is created because of an amendment to the limitation year, the defined contribution dollar limit must be prorated.[57] To prorate the limit, multiply the normal dollar limit by the following fraction:

$$\frac{\text{number of months (including fractional parts of a month)}}{12}$$

EXAMPLE 7-37. Short Limitation Year. A plan has a June 30 plan and limitation year. Effective January 1, 2018, the plan year and limitation year are amended to be the calendar year. There is a short period from July 1, 2017 through December 31, 2017. The defined contribution dollar limit for this period will be the 2017 dollar limitation ($54,000) x 6/12, or $27,000.

On the other hand, if a participant is eligible for only part of the year—that is, he or she entered the plan on an entry date during the year—the IRC §415 limitation is not prorated for that year. This is because the limitation is calculated with respect to the limitation year, regardless of whether a given employee is participating or even employed for the entire year.

If the initial plan year and limitation year are less than 12 months long because the plan is established mid-year, the dollar limitation must be prorated in the same manner as described above. However, if the plan is drafted so that the first plan year (and limitation year) are the full 12-month period ending on the last day of the year, the plan would use the unadjusted dollar limit to determine whether annual additions for the first year exceed the IRC §415 limits.

Effective for limitation years beginning on or after July 1, 1997, a termination of a defined contribution effective as of any date other than the last day of the plan's limitation year is treated as if the plan was amended to change the limitation year to a period ending on the termination date. If allocations are made in the plan year in which the termination occurs, any allocations in that year would be subject to a prorated dollar limitation.

COMPENSATION

Compensation for purposes of the 100 percent of compensation limitation is IRC §415 compensation. This is described in detail in the following section.

AGGREGATION OF PLANS

If an employer maintains more than one defined contribution plan, a participant's annual additions under all such defined contribution plans are aggregated to determine if the limitation has been exceeded.[58] If the employer is part of a related group (i.e., a controlled group or affiliated service group), the defined contribution plans maintained by all related group members are aggregated to determine if any participant's limitation has been exceeded. However, if an individual works for two employers that are not part of a related group, the individual's IRC §415 limit under the plans maintained by each employer is determined separately.

[56] Treas. Reg. §1.415(d)-1(b)(2)(iii).

[57] Treas. Reg. §1.415(j)-1(d)(2).

[58] IRC §415(f)(1)(B); Treas. Reg. §1.415(f)-1(a)(2).

If You're Curious . . .

Defined Contribution Plans with Different Limitation Years

If two or more defined contribution plans are maintained by an employer (or members of a group of related employers) with different limitation years, special rules apply for determining the applicable limitation year for the participants.

If the employee participates in only one of the plans, the limitation year is the year for that plan.

If the employee participates in more than one plan, the limitation year in each plan must be considered. To test whether the limit has been exceeded for any limitation year, all annual additions credited under all of the plans as of any date in such year must be considered.[59]

EXAMPLE 7-38. Multiple Limitation Years. Les is a participant in a money purchase plan and a 401(k) plan maintained by the same employer. The limitation year for the money purchase plan is the fiscal year ending June 30 (which coincides with the employer's tax year). The money purchase plan credits employer contributions and forfeitures as of June 30. There are no after-tax employee contributions in that plan. The 401(k) plan credits elective deferrals and matching contributions on a monthly basis and employer nonelective contributions every December 31. The limitation year for the profit sharing plan is the calendar year.

For the money purchase plan's limitation year July 1, 2017, through June 30, 2018, the June 30, 2018, money purchase allocation is aggregated with the 401(k) additions credited during this 12-month period. This will include elective deferrals and matching contributions for the period from July 1, 2017, through June 30, 2018, plus the profit sharing allocation as of December 31, 2017. Those additions will be compared to the 2018 annual additions limitation to determine if the limit has been exceeded. Les's IRC §415 compensation for that 12-month period is used for that determination.

The IRC §415 limit must also be tested on a calendar year basis for the profit sharing plan. For the limitation year January 1, 2018, through December 31, 2018, the elective deferrals, matching contributions and profit sharing allocation for that period will be aggregated with the June 30, 2018, money purchase allocation to determine if the IRC §415 limit has been exceeded. Les's IRC §415 compensation for the calendar year is used for that determination.

CONSEQUENCES OF EXCEEDING THE IRC §415 LIMITATIONS

IRC §401(a)(16) provides that compliance with IRC §415 is a requirement of plan qualification. Therefore, a failure to limit annual additions to the participants' accounts may cause a plan to be disqualified.

Correcting Excess Annual Additions

If a violation of the annual additions limit occurs, a plan sponsor may use the correction systems outlined in the Employee Plans Compliance Resolution System (EPCRS).[60] Other situations that do not fall within the corrections permitted below may also be resolved through the EPCRS.[61]

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[59] Treas. Reg. §1.415(j)-1(c)(2).

[60] Preamble to Final 415 Regulations, TD 9319 (4/7/2007), under "Limitations applicable to defined contribution plans" (§1.415(c)-1). See, also, Rev. Proc. 2008-50, IRB 2008-35, Appendix A, Section .08.

[61] Rev. Proc. 2013-12, IRB 2013-4, 231.

EPCRS Corection Methods

The current EPCRS procedures provide a means to eliminate the **excess amounts** (i.e., the annual additions that exceed the IRC §415 limitation). There are two primary procedures dependent on whether the amount would have been allocated to other participants has the excess allocation not occurred:

1. If, absent the excess allocation, the amount would have been allocated to other participants, the plan should reallocate the excess amounts to other participants who are not at their IRC §415 limits.[62]
2. If the excess amount would not have been allocated to other participants in absence of the overallocation, the excess amount is placed in an unallocated account and used (along with earnings on the unallocated amounts) in the following limitation year (and succeeding years, if necessary) to reduce employer contributions other than elective deferrals.

The excess amounts are treated as annual additions in the limitation year in which they are removed from the unallocated account and used as employer contributions. No additional contributions by the employer are permitted while there are funds in the unallocated account.[63]

Refunding Elective Deferrals and After-Tax Employee Contributions

If an excess amount is allocated to a participant's account and there have been elective deferrals or after-tax employee contributions made by the participant for the limitation year, the plan may provide for the distribution of elective deferrals and/or the return of after-tax employee contributions equal to the excess amount.[64] Distributed elective deferrals are taxed in the year distributed.[65] The premature distribution penalty applicable to participants who are under age 59½ does not apply. Many, if not most, plans provide for the correction under this method first, so that an employee's allocation of employer contributions is not reduced because of the employee's own elective deferrals or after-tax employee contributions.

If the elective deferral or after-tax employee contribution at issue is matched by the employer, the match should also be reduced. Because matching contributions are also annual additions, the reduction and distribution must be calculated together.

EXAMPLE 7-39. Distribution of Excess Deferral and Reduction of Matching Contribution to Correct IRC §415 Excess. Suppose that an employer matches all elective deferrals at the rate of 50 percent. Penny deferred $10,000 and received a $5,000 matching contribution. The plan administrator has determined that Penny has excess annual additions of $3,750. To determine the proper portion of the excess annual additions that is attributed to the elective deferral, an algebraic equation is developed under which the $3,750 amount to be reduced is divided by 1.5 (i.e., for every dollar of elective deferral, the match is fifty cents). This produces an elective deferral distribution of $2,500. The matching contribution to be forfeited is $1,250. (The equation would be different if the rate of match were different, or if the matching contribution is limited to a certain percentage of compensation.)

Elective deferrals distributed under this rule are disregarded for purposes of the elective deferral limit under IRC §402(g) and for purposes of the ADP test. Similarly, after-tax employee contributions returned under this rule are disregarded for purposes of the ACP test. If a matching contribution attributable to distributed elective deferrals or after-tax employee contributions is forfeited, the forfeited match is also disregarded for purposes of the ACP test.

Deadline for Correction

There is no specific deadline outlined in the regulations for making these corrections. However, until corrective action

[62] Rev. Proc. 2013-12, IRB2013-4, §6.06(2).
[63] *Id.*
[64] *Id.*
[65] Rev. Proc. 92-93, 1992-2 C.B. 505.

is taken, the plan has a disqualification failure. In addition, there are some practical considerations to think about. First, amounts being returned to participants are disregarded for ADP and ACP testing. Because those tests must be completed as of the last day of the plan year following the year in which the violation occurs, the corrective distributions need to be made in that time frame to properly do those calculations. Second, if the self-correction method under EPCRS is to be used, that program is time-limited unless the error is insignificant. Therefore, action is generally taken to address the possible IRC §415 problems within the EPCRS self-correction period.

Section 7.06: Compensation

The determination of how contributions and forfeitures are allocated is affected in many ways by the manner a participant's compensation is defined. This is true for many reasons. First, most allocations of contributions and forfeitures are based on the participant's compensation. Second, IRC §401(a)(17) limits the amount of compensation that may be taken into account for allocations, and it is important to determine how those limits affect an individual's compensation. Finally, IRC §415 limits the amount that may be allocated to a given participant's account to 100 percent of compensation (or a dollar limit, if less). It is important to understand what the definition of compensation is for IRC §415 purposes so that these limits may be applied correctly.

Generally, a plan must use a nondiscriminatory definition of compensation as the basis for allocations. The IRC defines several compensation definitions that are safe harbors; that is, that will qualify as nondiscriminatory compensation without a need for special testing. If one of those definitions is not used, the plan administrator must be able to demonstrate that the alternate definition is not discriminatory.[66]

SAFE HARBOR COMPENSATION DEFINITIONS

IRC §415 Compensation

A reference to **IRC §415(c) compensation** is a reference to compensation as defined for purposes of applying the limitations under IRC §415. IRC §415 compensation is used for many reasons. It is required, of course, to apply the limits under IRC §415. However, it is also required for:

1. Identifying HCEs;
2. Identifying key employees for top-heavy analysis; and
3. Calculating minimum contributions to non-key employees under top-heavy plans.

The definition of compensation for determining accrued benefits, or to allocate employer contributions, may (but is not required to) be IRC §415 compensation. Compensation used to perform nondiscrimination testing also may (but is not required to) be based on IRC §415 compensation.

There are three permissible definitions of compensation under IRC §415:

1. current includible compensation;
2. W-2 compensation; and
3. wages for income tax withholding definition.

Current Includible Compensation Definition

Under this definition, compensation includes all wages, salaries, fees and other amounts received by the employee for personal services rendered in the course of employment with the employer, but only to the extent includible in gross income.[67]

[66] IRC §414(s).

[67] Treas. Reg. §1.415(c)-2(a).

If You're Curious . . .

The current includible compensation definition includes overtime, bonuses, commissions, tips, fringe benefits (for example, taxable use of a company automobile) and reimbursements or other expense allowances under a nonaccountable plan [as described in Treas. Reg. §1.62-2(c)]. Compensation includes remuneration that is subject to the foreign earned income exclusion under IRC §911 (applicable to US citizens or residents living abroad), the exclusion under IRC §931 (income from sources within Guam, American Samoa or the Northern Mariana Islands) and the exclusion under IRC §933 (income from sources within Puerto Rico), even though such amounts are not actually subject to taxation.[68] Because workers' compensation is excludable from gross income [see IRC §104(a)(1)], such amounts would not be included under this definition.

If an individual is self-employed, as defined in IRC §401(c)(1), with respect to the employer who sponsors the plan, IRC §415 compensation from that employer means earned income [as defined in IRC §401(c)(2)].[69] Earned income is defined below. If the employer is a sole proprietorship, the only self-employed individual with respect to that employer is the sole proprietor, and the IRC §415 compensation will be determined from the net earnings from self-employment shown on Schedule C of the Federal income tax return [as adjusted under IRC §401(c)(2)]. If the employer is a partnership (or an entity taxed as a partnership, such as a limited liability company), the self-employed individuals with respect to the employer are the partners, and the IRC §415 compensation will be calculated from the distributive share of partnership income reported on the K-1 issued by the partnership [as adjusted under IRC §401(c)(2)].

W-2 Compensation

Under this definition, IRC §415 compensation is defined as wages [as determined under IRC §3401(a)], and other payments for which the employer must file a written statement (i.e., Form W-2) under:

- IRC §6041(d) (but only with respect to items of compensation to an employee of the employer);
- IRC §6051(a)(3) [referring to wages under IRC §3401(a)]; and
- IRC §6052 (referring to employer-provided group life insurance to the extent it is includible in gross income under IRC §79).[70]

Wages under IRC §3401 are wages for income tax withholding purposes. Therefore, the W-2 definition is similar to the definition shown below for withholding wages, but would be more inclusive. Any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed are disregarded. The IRS permits the plan to state this definition by referencing amounts reported as wages, tips or other compensation on Form W-2.

Terminology may differ from plan to plan. For example, some plan documents refer to W-2 compensation as IRC §6051 compensation or some similar designation that incorporates the IRC sections used to make the determination.

A self-employed individual does not receive a W-2 from the company. Therefore, a self-employed individual's W-2 compensation means earned income as defined in IRC §401(c)(1), even if the plan uses the W-2 definition for common law employees.[71]

Wages for Income Tax Withholding Definition

Under this definition, IRC §415 compensation is defined as wages under IRC §3401(a) for purposes of income tax with-

[68] Treas. Reg. §1.415-2(d)(2), last paragraph.
[69] Treas. Reg. §1.415(c)-2(b)(2).
[70] Treas. Reg. §1.415(c)-2(d)(4).
[71] Treas. Reg. §1.415(c)-2(b)(2).

holding at the source.[72] Any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed are disregarded. All amounts included in this definition would also be included in the W-2 compensation, so this definition is a less inclusive one than the W-2 definition.

Again, a plan's terminology might differ. Some plan documents refer to this definition as IRC §3401 compensation or some similar designation that incorporates the IRC section used to make the determination.

Plan's Definition for Accrual Purposes Does Not Affect IRC §415 Limit

A participant's IRC §415 compensation for purposes of applying the IRC §415 limit is not affected by the compensation definition used for benefit accrual purposes. For example, a defined contribution plan might allocate employer contributions to the account of an employee who becomes a participant on a mid-year entry date by taking into account compensation only for the second half of the year, but the entire year's compensation would be counted to determine IRC §415 compensation for purposes of calculating the annual additions limit under IRC §415(c). A plan also might exclude elective contributions under a 401(k) plan to determine compensation for benefit accrual or allocation purposes, even though such amounts are included in determining an employee's IRC §415 compensation.

IRC §414(s) Compensation

IRC §414(s) provides the rules for determining whether a definition of compensation is nondiscriminatory. **IRC §414(s) compensation** is required to be used for purposes of applying the nondiscrimination tests to employer-provided contributions and benefits,[73] elective deferrals,[74] permitted disparity formulas,[75] matching contributions and after-tax employee contributions.[76]

IRC §415 Compensation as Reference Point

All of the IRC §415 compensation definitions are safe harbor definitions of IRC §414(s) compensation.[77]

Safe Harbor Modifications to IRC §415 Compensation

The regulations permit three safe harbor modifications to the IRC §415 compensation definition to arrive at IRC §414(s) compensation. By treating these modifications as safe harbors, the modified definition of compensation is deemed to satisfy IRC §414(s) without any special testing required. In other words, the compensation ratio test would not need to be performed on these modified definitions to determine if they satisfy IRC §414(s). All three (or any combination) of the modifications described below may be made to the IRC §415 compensation definition without causing the definition to fail to satisfy IRC §414(s).

The three modifications are:

- Compensation may be reduced by all of the following items (even if they are included in gross income): reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation and welfare benefits.
- Compensation may include elective contributions that are made by the employer on behalf of the employees that are not included in gross income under IRC §§125, 402(e)(3), 402(h), 403(b), 457(b),

[72] Treas. Reg. §1.415(c)-2(d)(3).
[73] IRC §401(a)(4).
[74] IRC §401(k).
[75] IRC §401(l).
[76] IRC §401(m).
[77] Treas. Reg. §1.414(s)-1(c)(2).

414(h)(2) and 132(f)(4).[78]

- Compensation may exclude any portion of compensation earned by HCEs only.

PLAN'S DEFINITION OF COMPENSATION FOR ACCRUAL PURPOSES

A defined contribution plan must include a formula for allocating the employer's contribution to the participants' account balances. If the allocation formula is based on compensation, the plan must define how compensation will be determined.

Under a 401(k) plan, the plan's compensation definition also might affect how much an employee may defer each year under the 401(k) arrangement (e.g., elective deferrals limited to 15 percent of compensation), or how much of a matching contribution the employer will make for the employee [e.g., the matching formula is 100 percent of the first 3 percent of compensation deferred under the 401(k) arrangement]. The compensation definition in the plan that is used for accrual purposes may be IRC §415 compensation, IRC §414(s) compensation or a compensation definition that does not satisfy either definition.

For self-employed individuals (i.e., a sole proprietor or a partner of a partnership) covered by a plan, compensation will be based on earned income.

When determining an employee's compensation for contribution allocation purposes, the compensation is limited by the IRC §401(a)(17) compensation dollar limit.

Nondiscrimination Testing Safe Harbors

If the plan is intended to be a design-based safe harbor under the regulations of IRC §401(a)(4), with respect to the allocation of employer contributions (other than matching contributions), then the definition used for accrual purposes must satisfy one of the permitted definitions of IRC §414(s) compensation.[79] If the plan is not intended to be a design-based safe harbor under IRC §401(a)(4), then it does not matter how the plan defines compensation for accrual purposes. When the plan is tested for nondiscrimination, the allocation or benefit being tested will be expressed as a percentage of IRC §414(s) compensation, even though a different definition might have been used to determine how much was accrued by the employee for that year.

Dollar Limit on Compensation Taken into Account under the Plan

IRC §401(a)(17) limits the amount of compensation taken into account for the plan year when calculating a participant's accrual for that year.

Amount of Limitation

The **IRC §401(a)(17) compensation dollar limit** is subject to annual COLAs, but the applicable dollar amount must always be a multiple of $5,000.[80] The dollar limitation for plan years beginning in 2018 is $275,000.

Application of Limit to Defined Contribution Plans

The compensation limit applies to compensation used to calculate the amount of the employer's contribution under the plan's contribution formula, as well the compensation used to allocate the employer's contribution among the participants' accounts.

EXAMPLE 7-40. Money Purchase Contribution Formula. A money purchase plan provides for

[78] Treas. Reg. §1.414(s)-1(c).
[79] Treas. Reg. §1.401(a)(4)-12.
[80] IRC §401(a)(17)(B).

an employer contribution formula of 10 percent of compensation. The plan year ends December 31. Each participant's allocation equals the contribution made under the formula. An employee's annual compensation is $275,000. If the IRC §401(a)(17) dollar limit in effect as of the first day of the plan year is $275,000, then the employer contribution for this employee is $27,500, determined by multiplying the contribution percentage (10%) by $275,000 (i.e., the employee's compensation as limited by IRC §401(a)(17)].

EXAMPLE 7-41. Discretionary Profit Sharing Contribution. A profit sharing plan has a discretionary contribution formula. The employer's discretionary contribution for the plan year is $80,000. To determine an employee's share of that allocation under the plan's allocation formula, the employee's compensation is limited to the dollar limit in effect under IRC §401(a)(17) as of the first day of the plan year. Suppose the plan uses a pro rata allocation method, and Nick's actual compensation for the plan year is $300,000. Each of the other participants has compensation of $100,000 or less. The combined compensation of the participants (not including Nick) is $900,000. If the IRC §401(a)(17) limit in effect for the plan year is $275,000, then the total compensation of all participant's (including Nick) is $1,175,000 (i.e., $275,000 for Nick and $900,000 for the others). Therefore, Nick's share of the $80,000 contribution is $18,723, determined as follows: $275,000/$1,175,000 x $80,000.

Effect on Elective Contributions and Matching Contributions

The compensation dollar limit will affect any limitation placed on the participant's elective contributions or matching contributions that is based on a percentage of compensation. For example, suppose a 401(k) plan provides a 100 percent matching contribution on the first 3 percent of compensation deferred by a participant. Assume the compensation dollar limit in effect for the plan year is $275,000. Omar's actual compensation for the plan year is $300,000. His elective contributions total $11,000. Only $8,250 of Omar's elective contributions may be subject to the matching contribution because the 3 percent limit is calculated on Omar's capped compensation of $275,000. Omar's matching contribution is $8,250, which is 100 percent of the first 3 percent of compensation deferred by Omar. If Omar's actual compensation could be used, his matching contribution would be $9,000, which is 3% x $300,000. However, if the plan takes into account Omar's actual compensation to determine his match, it would be in violation of IRC §401(a)(17).

Earned Income

Earned income is a term used to define the compensation of a self-employed individual (i.e., a sole proprietor, a partner in a partnership or an owner of an entity that elects to be treated like a partnership for tax reasons, such as a limited liability company) who is covered by the plan.[81] The earned income definition should be used when compensation is otherwise used for qualified plan purposes, except where adjustments to that earned income are specifically required. This includes compensation for IRC §415 purposes, compensation used to determine allocations or benefits, compensation for calculating the deduction limit under IRC §404 and compensation for nondiscrimination testing purposes.

Net Earnings from Self-Employment

An individual's earned income is his or her net earnings from self-employment [as defined in IRC §1402(a)] with the modifications described in IRC §401(c). All adjustments taken into account in arriving at net earnings from self-employment are made, even if the self-employed individual separately reports such items.

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[81] IRC §401(c)(2).

If You're Curious . . .

How to Compute

The starting point for determining net earnings from self-employment will be:

- The Schedule C (line 31) or Schedule C-EZ (line 3), in the case of most sole proprietors,
- The Schedule K-1 (line 14a), in the case of partners of partnerships (or entities, such as LLCs, which are taxed as partnerships), or
- The Schedule F (line 36) for farming operations.

Then one must make any adjustments required by IRC §401(c)(2) as described below.

Only earnings from a trade or business in which the individual's personal services are a material income-producing factor are included.[82] In other words, if investment income (e.g., interest) is passed through the partnership to the partners, that income is not included in earned income. Similarly, a partner who is involved in the partnership as an investment only and is not active in the business operations would have no earned income.

Self-employment tax deduction under IRC §164(f). Earnings are reduced by the deduction allowed under IRC §164(f) for one-half of the individual's self-employment tax.[83]

Reduction of earned income for self-employed individual's qualified plan deduction. Earnings are reduced by the deductions allowed to the individual under IRC §404 for contributions to a qualified plan, including contributions allocated for the benefit of the self-employed individual.[84] For example, if an individual's earned income without a qualified plan deduction would be $160,000, but the IRC §404 deduction is $10,000, the individual's earned income is only $150,000. The $150,000 amount must be used to determine whether the contribution allocation exceeds any limitations, such as the IRC §415 limitation or the deduction limitation under IRC §404. The $150,000 amount is also used to determine whether the contribution satisfies the nondiscrimination requirements of IRC §401(a)(4).

When the employer is a sole proprietorship, the entire IRC §404 deduction for the year will reduce the earned income of the sole proprietor. When the employer is a partnership, the IRC §404 deduction is allocable among the partners. Thus, for each partner, the IRC §404 deduction taken into account under IRC §401(c)(2)(A)(v) is the partner's allocable share of the IRC §404 deduction relating to the common law employees and the portion of the IRC §404 deduction attributable to contributions made on behalf of the partner.

Personal Services must be Actually Rendered

Earned income only includes net earnings derived from the individual's personal services. Gains (other than capital gains) and net earnings derived from the sale or other disposition of property, or the licensing of the use of property, constitute earned income if the individual's personal efforts created such property.[85]

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[82] IRC §401(c)(2)(A)(I).
[83] IRC §401(c)(2)(A)(vi).
[84] IRC §401(c)(2)(A)(v).
[85] IRC §401(c)(2)(B); see also, Kramer v. Commissioner, 80 T.C. 768 (1983), regarding the treatment of royalties, if only the portion attributable to the individual's personal services was included as earned income.

Section 7.07: Determining Minimum Benefits Under Top-Heavy Plans

APPLICABLE COMPENSATION FOR TOP-HEAVY MINIMUM BENEFITS

If a plan is top-heavy, it must guarantee the non-key employees a minimum benefit. Compensation used to calculate the required minimum benefit must be IRC §415 compensation.[86] The plan may not use a lesser definition of compensation to determine the minimum benefit. For example, if a top-heavy plan excludes elective deferrals to determine a non-key employee's allocable share of employer contributions, the elective deferrals must be added back, as required under the IRC §415 compensation definition, to determine if the allocation satisfies the employee's guaranteed minimum benefit under the top-heavy rules.

If You're Curious . . .

TOP-HEAVY MINIMUM BENEFITS

If the plan is top-heavy, the allocation made to a participant in a defined contribution plan or the benefit accrued under a defined benefit plan must satisfy certain minimum benefit standards under IRC §416(c). These minimum benefit standards will affect the way employees accrue their benefits under the plan.[87]

Remember that a plan's top-heavy status can change from year-to-year. If the plan is not top-heavy for a particular plan year, then the minimum accrual requirements described in this section do not have to be satisfied.

Minimum Allocation Requirement Under Top-Heavy Defined Contribution Plans

As a general rule, a non-key employee's allocation under a top-heavy plan must not be less than 3 percent of IRC §415 compensation for the entire plan year.[88] If the employee's allocation is equal to or more than 3 percent, then no further contribution is required to satisfy the top-heavy rules. But, remember, there might be other reasons why a greater contribution might have to be provided (for example, the plan is unable to satisfy the nondiscrimination testing requirements under IRC §401(a)(4), based on the amounts that have been allocated).

If a non-key employee becomes a participant during the year (e.g., July 1 entry date in a calendar year plan), the 3 percent minimum allocation must be based on the employee's compensation for the entire plan year. If the plan allocates employer contributions only on compensation from the employee's initial entry date to the end of the plan year, and the entry date is not the first day of the plan year, the amount so allocated will have to be compared to 3 percent of the employee's compensation for the entire plan year to determine if the top-heavy minimum has been satisfied.[89]

Examples

Note that all of the examples below assume that one or more key employees have received allocations of contributions equal to at least 3 percent of compensation. If this were not so, the top-heavy mini-

[86] IRC §416(c) and Treas. Reg. §1.416-1, T-21.
[87] See Audit guidelines on the top-heavy rules in Announcement 95-33, although these guidelines predated EGTRRA, and have not been updated.
[88] IRC §416(c)(2).
[89] Treas. Reg. §1.416-1, M-7.

mum contribution would be adjusted accordingly.[90]

EXAMPLE 7-42. Plan Allocation Exceeds Top-Heavy Minimum. A profit sharing plan provides for a pro rata allocation formula. Christopher's compensation for the plan year is $30,000. The plan is top-heavy. For the current plan year, the employer contributes an amount equal to 5 percent of eligible compensation. Christopher's allocation is 5% x $30,000, or $1,500. The top-heavy minimum allocation for Christopher is 3% x $30,000, or $900. Because Christopher's allocation exceeds the top-heavy minimum allocation, the plan has satisfied the top-heavy requirement.

EXAMPLE 7-43. Partial-Year Compensation Used to Determine Allocations. Roger becomes a participant in a top-heavy profit sharing plan on the mid-year entry date. Under the plan, an employee who becomes a participant on the mid-year entry date receives an allocation based on his compensation for the last six months of the plan year.

For the current plan year, Roger's compensation for the last six months is $15,000. His account is credited with an allocation of employer contributions equal to 5 percent of that compensation (i.e., 5% x $15,000, or $750). Roger's compensation for the entire plan year is $30,000. The top-heavy minimum allocation requirement is $900 (which is based on Roger's 12 months of compensation for the entire plan year).

The plan has not satisfied the top-heavy requirement because Roger's allocation is only $750. The plan will have to allocate an additional $150 to Roger to satisfy the top-heavy minimum allocation requirement. (Most plans include a fail-safe provision, pursuant to which the employer will make up the difference through an additional contribution to the plan on the affected participant's behalf.)

EXAMPLE 7-44. Categories of Compensation Excluded for Allocation Purposes. Each eligible participant in a money purchase plan receives an employer contribution allocation in an amount equal to 4 percent of compensation. Compensation is defined as base salary, exclusive of bonuses and overtime. Andrea, a non-key employee, has a base salary of $20,000. Her allocation for the plan year is 4% x $20,000, or $800. However, Andrea's bonuses and overtime for the plan year total $10,000. Her top-heavy minimum allocation is calculated on her total compensation of $30,000. The top-heavy minimum allocation for Andrea is 3% x $30,000, or $900. Because her allocation ($800) is less than the top-heavy minimum allocation ($900), the plan has not satisfied the top-heavy requirement.

EXAMPLE 7-45. Cafeteria Plan Contributions Made by Participant. A profit sharing plan allocates employer contributions based on a participant's net compensation (i.e., compensation remaining after cafeteria plan contributions are subtracted). Turrell's net compensation for the plan year is $36,000. His cafeteria plan contributions for the year, which are used to purchase health insurance benefits, total $4,000. Turrell's IRC §415 compensation is $40,000. The top-heavy minimum allocation is 3% x $40,000, or $1,200, because IRC §415 compensation must be used.

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[90] See Chapter 5.

EXAMPLE 7-46. Elective Contributions Under 401(k) Arrangement. Suppose in the prior EXAMPLE 7-45 that the profit sharing plan includes a 401(k) arrangement. Turrell's elective contributions to the 401(k) arrangement for the plan year total $2,000. The net compensation reflects Turrell's compensation after the elective contributions are deducted. Thus, Turrell's IRC §415 compensation is $42,000 [i.e., $36,000 + $4,000 cafeteria plan contributions + $2,000 elective contributions to the 401(k) arrangement]. The top-heavy minimum allocation is now 3% x $42,000, or $1,260.

Short Plan Year

If the plan has a short plan year, a top-heavy minimum contribution must be satisfied for the short year as well. The minimum contribution is 3 percent (or the lesser percentage) of the participant's IRC §415 compensation for the short plan year. There are no regulations specifically addressing this rule. However, because the regulations base the top-heavy minimum on compensation for the plan year, and do not include any exception to the rule for short plan years, this result is implied.

Section 7.08: Review of Key Concepts

- Describe the conditions that may be imposed on a participant to be eligible for a contribution allocation.
- Name some allowable allocation methods.
- Calculate a participant's allocation using the pro rata allocation method.
- What is the annual addition limit under IRC §415 and what are the consequences of exceeding this limit?
- How do you correct an excess annual addition?
- What are the differences between IRC §414(s) compensation and IRC §415 compensation?
- When must IRC §414(s) and/or IRC §415 compensation be used?
- Describe when a plan's definition of compensation may be subject to additional nondiscrimination testing.

Section 7.09: For Practice – True or False

1. A plan must have both a contribution formula and an allocation formula.
2. A last-day employed condition on receiving an allocation will not affect a plan's coverage testing under IRC §410(b).
3. A plan may use a different definition of compensation for allocation purposes and nondiscrimination testing.
4. Compensation used to calculate the required minimum benefit in a top-heavy plan must be IRC §415 compensation.
5. The IRC limits the amount of compensation that may be considered for allocation purposes.
6. A non-top-heavy plan could have a requirement that a participant complete at least 750 hours of service in the plan year to be eligible for a contribution allocation.
7. The annual additions limit under IRC §415 is the greater of 100 percent of IRC §415 compensation or $40,000, as indexed.
8. Elective contributions that are characterized as catch-up contributions are not included in a participant's annual addition limit.
9. Allocations that do not satisfy the safe harbor requirements will need to show they are nondiscriminatory by passing the general test.

10. A participant may need to be employed on the last day of the plan year to be eligible for a minimum top-heavy allocation.

Section 7.10: Sample Test Questions

1. Based on the following information, determine the allocation to Participant B for 2016:
    - The plan is a calendar year profit sharing plan with an effective date of January 1, 2018.
    - The allocation formula is pro rata based on compensation.
    - The IRC §401(a)(17) compensation limit for 2018 is $275,000.
    - There are no forfeitures in 2018.
    - The plan is not top-heavy.
    - The 2018 contribution totals $40,000.

Eligible Participant	2018 Compensation
A	$210,000
B	$80,000
C	$45,000
D	$30,000

A. $0
B. $8,649
C. $8,767
D. $8,889
E. $40,000

2. All of the following are included in a participant's annual addition limit under IRC §415, EXCEPT:

A. Profit sharing contribution
B. Employer matching contribution
C. Designated Roth contribution
D. After-tax employee contribution
E. Elective deferral under IRC §125 (cafeteria plan)

3. Based on the following information, determine the number of participants that have satisfied the IRC §415 annual additions limit:
    - The employer sponsors one plan, a 401(k) plan.
    - The plan year and limitation year is calendar year 2018.
    - The defined contribution annual addition dollar limit for 2018 is $55,000.
    - Participant A is the only catch-up eligible participant.
    - The plan satisfies all coverage and nondiscrimination requirements.

Participant	IRC §415 Compensation	Elective Contributions	Catch-Up Contributions	Employer Contributions
A	$200,000	$18,000	$6,000	$35,000
B	$150,000	$18,000	$0	$38,000
C	$100,000	$10,000	$0	$30,000
D	$95,000	$8,000	$0	$23,000

A. None
B. One only
C. Two only
D. Three only
E. Four

4. Which of the following is/are instances in which IRC §415 compensation must be used?
    I. To determine HCEs
    II. In ADP testing
    III. When allocating employer contributions

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

5. Which of the following statements regarding excess annual additions is/are TRUE?
    I. A plan may provide for a refund of after-tax employee contributions that are excess annual additions.
    II. A plan may provide for a refund of elective deferrals that are excess annual additions.
    III. A failure to limit annual additions to the participants' accounts may cause a plan to be disqualified.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

6. All of the following statements regarding conditions for receiving an allocation of contributions under a plan are TRUE, EXCEPT:
    A. It is permissible for a plan to waive allocation requirements for a participant if the participant dies during the plan year.
    B. It is permissible for a plan to waive allocation requirements for a participant if the participant becomes disabled during the plan year.
    C. It is permissible for a plan to waive allocation requirements for a participant if the participant retires during the plan year.
    D. It is permissible for a plan to condition the allocation of nonelective contributions on whether the employee makes elective contributions under the 401(k) arrangement.
    E. It is permissible for a plan to waive allocation requirements for a participant who returns from military service.

7. Which of the following statements regarding compensation is/are TRUE?
    I. W-2 compensation is a permissible definition of compensation under IRC §415.
    II. A compensation definition that excludes any portion of compensation earned by NHCEs only is deemed to be nondiscriminatory.
    III. Current includible compensation is a permissible definition of compensation under IRC §415.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

8. Which of the following statements regarding contributions and allocations is/are TRUE?
   I. A mid-year entrant's hours of service for the entire plan year are counted for allocation purposes.
   II. A plan's allocation formula identifies how the amount deposited into the plan is determined.
   III. A plan's contribution formula specifies how the contribution is apportioned to the participant accounts.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

9. Based on the following information, determine the employer contribution for the 2018 plan year:
   - The plan is a calendar year money purchase plan and is the only plan of the employer.
   - Contributions are allocated in proportion to compensation to participants who worked at least 1,000 hours in the plan year and who are employed on the last day of the plan year.
   - The employer contribution is 10% of eligible compensation.
   - Forfeitures are used to reduce the employer contribution and total $2,000 for the 2018 plan year.
   - The IRC §401(a)(17) compensation limit for 2018 is $275,000.
   - Participant W terminated employment on October 15, 2018.
   - The plan satisfies coverage requirements.

Participant	Hours Worked	Compensation
U	2,080	$500,000
W	1,650	$60,000
X	2,080	$50,000
Y	2,080	$45,000
Z	2,080	$35,000

   A. $35,000
   B. $38,500
   C. $40,500
   D. $61,000
   E. $63,000

10. All of the following statements regarding annual addition limits under IRC §415 are TRUE, EXCEPT:
   A. Contributions are treated as annual additions assuming they are deposited no later than 30 days after the period during which the contributions were deductible.
   B. A participant who enters the plan mid-year has a prorated annual addition limit.

C. The annual addition dollar limit is based on the dollar limit in effect as of the end of the limitation year.
D. If a short limitation year is created because of an amendment to the limitation year, the IRC §415 dollar limit must be prorated.
E. The defined contribution dollar limit is subject to cost-of-living adjustments in $1,000 increments.

See next page for answers to the true/false and sample test questions.

Section 7.11: Solutions to True or False Questions

1. True.
2. False. Imposing a last-day employment condition on an allocation may affect coverage testing because participants in the coverage testing group who terminate employment before the end of the plan year will not be considered benefiting.
3. True.
4. True.
5. True.
6. True.
7. False. The annual additions limit is the lesser of 100 percent of IRC §415 compensation or $40,000, as indexed.
8. True.
9. True.
10. True.

Section 7.12: Solutions to Sample Test Questions

1. The answer is **C**. Total compensation for all eligible participants is $210,000 + $80,000 + $45,000 + $30,000 = $365,000. Participant B's allocation is ($80,000 / $365,000) * $40,000 = $8,767
2. The answer is **E**. lective deferrals to an IRC §125 plan are not included in determining a participant's annual addition limit under IRC §415.
3. The answer is **D**. The annual additions limit is the lesser of 100 percent of IRC §415 compensation or $55,000 for 2018. Elective deferrals and employer contributions are included as annual additions, but catch-up contributions are not. Total annual additions for each participant are as follows:
   Participant A: $18,000 + $35,000 = $53,000
   Participant B: $18,000 + $38,000 = $56,000 – exceeds the dollar limit for 2018
   Participant C: $10,000 + $30,000 = $40,000
   Participant D: $8,000 + $23,000 = $31,000
   Three of the four participants satisfy the IRC §415 annual additions limit.
4. The answer is **A**. IRC §415 may be used in ADP testing or for allocating employer contributions, but it is not a requirement.
5. The answer is **E**. All of the statements are true.
6. The answer is **D**. Only matching contributions under the 401(k) plan may be conditioned on the basis of elective contributions.
7. The answer is **C**. A compensation definition that excludes any portion of compensation earned by HCEs only is deemed to be nondiscriminatory.
8. The answer is **A**. A plan's contribution formula identifies how the amount deposited into the plan is determined (i.e., how much will be contributed) while a plan's allocation formula specifies how the contribution is apportioned to the participant accounts (i.e., how much will be allocated to each participant).
9. The answer is **B**. articipant W is not eligible for a contribution due to termination of employment. Compensation for Participant U must be limited to the IRC §401(a)(17) limit for 2018, which is $285,000. 10 percent of the total includible compensation for eligible participants is $40,500 [($275,000 + $50,000 + $45,000 + $35,000) X 10%]. The $2,000 forfeiture is used to reduce the employer contribution obligation. Thus, the employer contribution for 2018 is $38,500.
10. The answer is **B**. If a participant is eligible for only part of the year—that is, he or she entered the plan on an entry date during the year—the IRC §415 limitation is not prorated for that year.

CHAPTER 8:
DEDUCTIONS

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Section 8.01: Key Terms

- Beneficiaries
- Compensation
- Deduction limit
- Excise tax
- Overlapping plans

Section 8.02: Introduction

An important consideration for sponsors of qualified plans is the deductibility of contributions to the plans. After all, if the employer simply paid compensation directly to the employees, these amounts would be deductible so long as they were reasonable. The employer does not want to lose deductibility of amounts paid for the benefit of employees simply because they are contributed to a plan rather than paid in cash.

Another consideration is the timing of the deduction. A contribution is deductible under IRC §404(a)(6) so long as it is made during the tax year to which it applies. In addition, a grace period exists that permits the employer to contribute the relevant amount to the plan anytime after the tax year, but no later than the tax return due date for the tax year to which the deduction applies. The employer may then deduct that contribution for the prior tax year. For example, a contribution may be made up to April 17, 2018, in relation to the 2017 calendar corporate tax year and be deductible for 2017. If the corporation extends its tax return until October 15, 2018, the contribution may be made anytime up to that date.

This chapter will discuss the rules surrounding deductibility of contributions, including the amounts that are deductible and the timing of the contributions in order for them to be deductible for a given year. Furthermore, we will discuss the ramifications of failing to satisfy the deduction rules.

Section 8.03: Tax Deductions for Contributions

CURRENT DEDUCTION TO EMPLOYER

One of the most significant tax advantages offered by a qualified plan is the current deduction available to the employer, even though the employees generally do not realize income until distribution is made from the plan.

The deduction rules work the same way regardless of whether the employer's contribution is in cash or property. If property is contributed, the amount of the contribution is the fair market value of that property for purposes of determining whether the contribution exceeds the deduction limit under IRC §404. However, the contribution of property to a pension plan has been determined to be a prohibited transaction. In addition, the contribution of encumbered property is also a prohibited transaction, even if the plan is a nonpension plan.[1]

DEDUCTION LIMIT FOR DEFINED CONTRIBUTION PLANS

According to the general **deduction limit** prescribed by IRC §404(a)(3), the maximum permissible deduction for defined contribution plans is 25 percent of the aggregate compensation of the eligible participants. Elective contributions made by the participants under a 401(k) arrangement are deducted separately and do not consume any part of the 25 percent available for other employer contributions to the plan.

[1] *Commissioner v. Keystone Consolidated Industries, Inc.* 113S.Ct.2006 (1993), DOL Interp. Bulletin §2509.94-3.

If You're Curious . . .

Special ESOP Deduction Rule

There are special deduction rules with respect to ESOPs.[2] First, a special additional deduction is available if the ESOP has borrowed money to buy stock and a larger contribution is needed to repay the loan. Second, the payment of certain dividends on the employer stock is deductible. These special deductions will not be discussed further in this chapter, but are covered in *The ASPPA Defined Contribution Plan Series Volume 3: Advanced Compliance and Administration Topics*, available at ecommerce.asppa-net.org.

Definition of Compensation for Deduction Purposes

The **compensation** taken into account for deduction purposes is all compensation paid or accrued to the participants during the employer's taxable year.[3] The reference to "accrued" compensation relates to bonus payments that are in relation to a given fiscal year but paid in the next fiscal year by an accrual basis taxpayer. Certain elective contributions are added back to compensation to compute the deduction limit and certain imputed compensation is also taken into account.

The following elective contribution amounts are added back to compensation for purposes of calculating the deduction limit (referred to as "grossing up" the compensation):[4]

- Elective contributions under a 401(k) plan;
- Elective contributions under a SIMPLE IRA plan;
- Elective contributions under a SARSEP [salary reduction SEPs, as described in IRC §408(k)(6)]. SARSEPs cannot be established after 1996, but SARSEPs in existence before 1997 may continue to be funded;
- Salary reduction contributions under a cafeteria plan, pursuant to IRC §125; and
- Salary reduction amounts used to purchase qualified transportation fringe benefits, pursuant to IRC §132(f)(4).

Amounts deferred at the employee's election under a 403(b) plan or a 457 plan are also included in the statute's definition of compensation. However, the types of employers that would be maintaining those types of arrangements would not be claiming deductions, because they would either be tax-exempt organizations or governmental entities.

EXAMPLE 8-1. Effect of 401(k) Elective Contribution. Corporation X maintains a profit sharing plan with a 401(k) arrangement. Corporation X's taxable year is the calendar year. Kevin's annual compensation is $40,000. Kevin makes pre-tax elective contributions of $2,000 under the 401(k) arrangement. To compute Corporation X's maximum deduction, Kevin's compensation is $40,000, even though his taxable compensation would be $38,000.

EXAMPLE 8-2. Effect of Cafeteria Plan Contribution. Suppose in the prior EXAMPLE 8-1 that Kevin further reduces his salary by $1,000 to purchase benefits under Corporation X's cafeteria plan. Kevin's compensation for purposes of computing Corporation X's maximum deduction for the taxable year is still $40,000, even though his taxable compensation would be $37,000.

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[2] IRC §404(a)(9).
[3] Treas. Reg. §1.404(a)-9(b).
[4] IRC §404(a)(12).

Plan's Compensation Definition for Allocation Purposes Might be Different

The way the plan defines compensation for allocation purposes does not affect the way compensation is determined for calculating this deduction limit. Compensation used for allocation purposes under the plan might exclude certain categories of compensation, might be based on just a portion of the plan year because of eligibility rules or might treat elective contributions differently from the way they are treated for deduction limit purposes.

EXAMPLE 8-3. Plan Allocates Employer Contributions by Excluding Certain Amounts from the Definition of Compensation. A profit sharing plan defines compensation for allocation purposes as base salary, which excludes bonuses and overtime pay. Sally's base salary is $40,000. Her bonus for the year is $3,000. She does not earn overtime pay. For allocation purposes, Sally's compensation is $40,000. To compute the deduction limit, the employer treats Sally's compensation as $43,000.

EXAMPLE 8-4. Plan Allocates Employer Contributions by Limiting Compensation to the Period During Which the Employee is Eligible. Suppose in the prior **EXAMPLE 8-3** that the plan measures a new participant's compensation from the date of entry to the end of the plan year for allocation purposes. Assume Sally became a participant in the plan on the mid-year entry date of July 1. Her base salary from July 1 to December 31 is $21,000. For allocation purposes, Sally's compensation is $21,000. In determining the combined compensation of the plan participants in order to compute the employer's maximum deduction, Sally's compensation is still $43,000, as shown in the prior EXAMPLE 8-3—that is, her total compensation for the full plan year.

EXAMPLE 8-5. Plan Excludes Elective Contributions for Allocation Purposes. A 401(k) plan provides for an employer nonelective contribution. The contribution is allocated on the basis of IRC §415 compensation reduced by the amount of elective contributions made by the participant. Tim has annual compensation of $65,000. He defers $11,000 into the 401(k) plan, leaving "net" compensation of $54,000. He does not participate in any other 401(k) arrangements. Under the deduction rules, the employer treats Tim's compensation as $65,000 for purposes of calculating its deduction limit, even though the plan only counts $54,000 of Tim's compensation to determine his allocation of employer nonelective contributions.

In practice, it is unusual for a company to base its nonelective contribution on compensation net of elective contributions. This is because it is a disincentive to defer, as a participant who defers will have less compensation on which the nonelective contribution is allocated, and therefore will receive a lesser nonelective contribution than if he or she did not defer.

If You're Curious . . .

Plan Year Might Differ From Employer's Taxable Year

Another reason that the compensation used for allocation purposes might be different from the compensation used for deduction limit purposes is the period over which compensation is calculated. For allocation purposes, the plan typically uses the plan year (or the portion of the plan year during which the employee is eligible, as illustrated in **EXAMPLE 8-4**. On the other hand, the deduction limit must be calculated on the basis of compensation for the employer's taxable year. If the employer's taxable year is different from the plan year, then the aggregate compensation used for the deduction limit calculation might be different from the aggregate compensation used for allocation purposes, even if it involves identical participants.

Earned Income Used for Self-Employed Individuals

If the plan covers a self-employed individual, compensation means earned income. However, earned income is also grossed up for elective contributions. For example, if the self-employed individual has earned income of $100,000 and $10,000 of that is deferred to the 401(k) plan, the individual's compensation for deduction purposes is $100,000. Remember, however, that a self-employed individual's compensation does not include nonelective contributions or matching contributions.

Deduction Limit Is an Aggregate Limit

The IRC §404(a)(3) deduction limit is an aggregate limit on the total tax deduction for employer contributions made for all participants to the plan. That means it is determined at the employer level, based on the compensation of all participants in the plan. The IRC §404(a)(3) deduction limit is not an individual limit on each participant.

A participant's share of the employer contributions for the plan year might exceed 25 percent of his or her compensation. The individual limit on a participant's allocation is outlined in IRC §415—the lesser of 100 percent of IRC §415 compensation or an indexed dollar limit ($55,000 for 2018).

EXAMPLE 8-6. Deduction is Applied in the Aggregate. A profit sharing plan has 25 participants, whose combined compensation for the employer's taxable year beginning on January 1, 2018, is $900,000. The deduction limit for the 2018 taxable year is 25 percent x $900,000, or $225,000. The employer makes the maximum deductible contribution.

Sonya, one of the 25 participants, has annual compensation of $120,000. Under the plan's allocation formula, $40,000 of the total contribution is allocated to her account. Although $40,000 is 33 ⅓ percent of her compensation, the deduction limit is not exceeded. The 25 percent deduction limit for 2018 applies to the total employer contribution ($225,000), not the contribution allocated to any individual participant.

Application of IRC §404(a)(3) to Money Purchase Plans

Money purchase plans (including target benefit plans) are subject to the IRC §404(a)(3) deduction limit of 25 percent of aggregate compensation.[5]

Maintaining Both a Money Purchase Plan and a Profit Sharing Plan Does Not Increase Overall Deduction Limit

An employer cannot increase its deduction limit to a level higher than 25 percent by maintaining a money purchase plan in addition to the profit sharing plan. All defined contribution plans of an employer are aggregated for purposes of determining whether the 25 percent limit is exceeded.

Exceeding the 25 Percent Deduction Limit with a 401(k) Arrangement

Elective contributions are fully deductible under a separate subsection of IRC §404. Therefore, a company may deduct up to 25 percent of compensation for the profit sharing contribution and any matching or other employer nonelective contributions, plus an unlimited amount for elective contributions.[6] Individual plan participants are subject to the elective deferral limits under IRC §402(g), but the plan as a whole is not subject to a limit on the total dollar amount of elective deferrals that may be deducted.

[5] IRC §404(a)(3)(A)(v).
[6] IRC §404(n).

EXAMPLE 8-7. Maximum Deductible Contributions Under 401(k) Plan. A company maintains a profit sharing plan with a 401(k) arrangement. The plan year and the employer's taxable year are the calendar year. The total gross compensation of all participants is $2,000,000. The total 401(k) elective contributions made by all the participants is $140,000. The employer's deduction limit for the plan year is 25 percent of $2,000,000, or $500,000. This limit applies to all employer contributions other than elective contributions (i.e., matching contributions and/or nonelective contributions). If the employer contributes the full $500,000 in the form of nonelective contributions, matching contributions or a combination of both matching contributions and nonelective contributions, the employer's total qualified plan deduction is $640,000. The $140,000 of elective contributions are fully deductible in addition to the $500,000 of nonelective contributions and matching contributions.

Catch-up Contributions for Participants Over Age 50

A 401(k) or 403(b) plan may allow participants who are at least age 50 by the end of the calendar year to make catch-up contributions, which are elective contributions that are in excess of otherwise applicable limits.[7] All elective contributions are deductible in full, regardless of whether they are "regular" elective contributions or catch-up contributions.

If You're Curious . . .

Special Deduction Rules for Elective Contributions and Matching Contributions

The IRS has taken the position that, if employer contributions are made after the close of the taxable year but before the company's tax return due date (including extensions), such contributions are only deductible if they are attributable to compensation earned in the taxable year for which the tax return is filed.[8]

401(k) Regulations Reinforce Contribution Timing Rules for Post-2005 Plan Years

Treas. Reg. §§1.401(k)-1(a)(3)(iii) and 1.401(m)-1(a)(2)(iii) preclude prefunding of elective contributions and matching contributions. These regulations treat a contribution as not being an elective contribution (or a matching contribution attributable to an elective contribution) if the contribution is made:

1. Before the employee performs the services with respect to which the elective contribution is made, or
2. With respect to compensation that becomes currently available after the date of the contribution.[9]

The effect of this rule is to treat any amount contributed as prefunded elective contributions or match as a contribution of nonelective contributions (i.e., discretionary contribution to the underlying profit sharing plan) that would have to be allocated in accordance with the terms of the plan pertaining to such contributions. The employer would then be required to correctly fund the employee contributions and/or the related match. These regulations were effective for plan years beginning on or after January 1, 2006.

Refunded Elective Deferrals Are Still Deductible by Employer

The plan might refund a portion of a participant's elective contributions under a 401(k) arrangement. This might occur because the elective contributions exceeded the maximum elective contribution

[7] IRC §414(v).

[8] Rev. Rul. 90-105.

[9] Treas. Reg. §1.401(k)-1(a)(3)(vii), Example 3 and Example 4.

dollar limitation under IRC §402(g) (called excess deferrals). This also might occur because the participant is an HCE, and a refund of a portion of his or her elective contributions is required to satisfy the ADP nondiscrimination test (called excess contributions). Regardless of the reason, the refund of the elective contributions does not affect the employer's calculation of its deductible contribution. The total elective contributions made by the employer to the plan are still fully deductible, including the amounts eventually refunded either because they are excess deferrals under IRC §402(g) or excess contributions under the nondiscrimination tests. The participant will, in turn, consider the amount refunded by the plan as income, which will be reported as taxable to the employee on Form 1099-R.

EXAMPLE 8-8. Effect of Excess Contributions on Deductions. Melissa's annual compensation is $120,000. She makes an elective contribution of $17,000 into the employer's 401(k) plan for the plan year. Following the close of the plan year, it is determined that $2,000 of Melissa's 401(k) elective contributions must be refunded to satisfy the ADP nondiscrimination test. The plan reports that refund on Form 1099-R. Although Melissa is effectively able to retain only $15,000 of the $17,000 of elective contributions in the plan, the employer has still contributed elective contributions on her behalf in the amount of $17,000. The full amount is deductible by the employer, as provided in IRC §404(n).

One-Person 401(k) Plans

Consider a situation in which an individual is the sole employee of a corporation. The corporation pays him or her $100,000 per year. The maximum deductible contribution for the employer to a profit sharing plan is 25 percent of the sole participant's compensation.[10] But, if a 401(k) arrangement is added to the profit sharing plan, the participant may make elective contributions up to the permissible statutory limits, and the corporation may take a deduction for those contributions in addition to the 25 percent deduction for the employer's nonelective contributions.

For calendar year 2017, the elective deferral dollar limit under IRC §401(a)(30) is $18,000, so this sole participant, who earns $100,000 of compensation, could defer $18,000 under the 401(k) arrangement and still have the corporation fund an additional discretionary profit sharing contribution on his or her behalf in the amount of $25,000 (i.e., 25% x $100,000). Thus, the corporation will deduct (and the employee will receive an allocation of) $43,000, or 43 percent of compensation. If the participant is catch-up eligible, an additional $6,000 may be deferred into the 401(k) plan, for a total of $24,000 of elective contributions, or $49,000 (49 percent of compensation) total.

Taxable Year Different From Plan Year

In some cases, the employer's taxable year will be different from the plan year. Even if the employer's contribution is allocated based on compensation for the plan year, the deduction limit always must be calculated on the basis of compensation for the employer's taxable year.

EXAMPLE 8-9. Taxable Year Different From Plan Year. Corporation Z maintains a profit sharing plan. The plan year is the calendar year. Corporation Z's taxable year ends September 30. For the taxable year October 1, 2017, through September 30, 2018, the total compensation of all participants in the plan is $600,000. The 25 percent deduction limit for the taxable year ending September 30, 2018, is $150,000. Corporation Z contributes $150,000 on September 1, 2018. That contribution is fully deductible for the taxable year ending September 30, 2018. The contribution is allocated for the 2018 calendar plan year. That allocation will be based on compensation for the plan year (i.e., calendar year 2018), in accordance with the formula stated in the plan, even though the deductibility of that contribution was based on the compensation of the participants for the taxable year ending September 30, 2018.

[10] IRC §404(a)(3).

If You're Curious . . .

In **EXAMPLE 8-9**, Corporation Z allocated the September 1, 2018, contribution for the 2018 plan year that ended December 31, 2018. Could Corporation Z designate the contribution for allocation in the 2017 plan year, but still deduct it for the taxable year ending September 30, 2018? Yes! The language in IRC §404(a)(3)(A) has caused some confusion here because it states that contributions are deductible in the taxable year when paid (the taxable year ending September 30, 2018, in the example) if "such taxable year ends within or with a taxable year of the trust with respect to which the trust is exempt under" IRC §501(a) (i.e., a year for which the plan is qualified). Some people make the mistake of thinking that this language means the contribution must be allocated for the plan year in which the taxable year ends (e.g., the plan year ending December 31, 2018, in the example). But the statutory language does not require this. It simply says the taxable year must end in a trust year for which the plan is qualified, but that year does not have to be the same year that the contribution is allocated. In the example, the contribution is deductible for the taxable year ending September 30, 2018, because that taxable year ends in a trust/plan year (i.e., January 1 to December 31, 2018) for which the plan is qualified. But the contribution may be allocated for the prior trust/plan year (i.e., the trust/plan year in which the taxable year begins, January 1 to December 31, 2017) instead, so long as the plan is qualified in that plan/trust year.

The regulations under IRC §415 also would support the allocation of the September 1, 2018, contribution for the plan year ending December 31, 2017. Treas. Reg. §1.415-6(b)(7)(ii) permits an employer contribution to be treated as an annual addition for a prior limitation year if the contribution is made no later than the 30 days following the IRC §404(a)(6) grace period (i.e., the due date, including extensions, for filing the employer's tax return for the taxable year in which the limitation year ends). Assuming in the example that the IRC §415 limitation year is the same as the plan year (which it usually is), the 2017 plan year ends in the taxable year ending September 30, 2018 (i.e., December 31, 2017, falls within the taxable year period that runs from October 1, 2017, through September 30, 2018). The contribution made on September 1, 2018, is during that taxable year, so it is made clearly within the time frame described in the IRC §415 regulation. In fact, the contribution could be made as late as 30 days after the due date for filing the September 30, 2018, tax return and still be allocated for the 2017 limitation year under the IRC §415 limits. However, to be deductible for the September 30, 2018, taxable year, the contribution would have to be made by the due date of the return for that year (not during the 30 days that follows that due date).

Plan Years Differing From Taxable Years Might Facilitate Employer's Realization of 25 Percent Deduction Limit in Some Years

The 25 percent deduction limit is usually going to exceed what an employer is willing to contribute for a single plan year, especially because the elective contributions under a 401(k) arrangement are not counted against that 25 percent limit. Maintaining a plan year that differs from the employer's taxable year, however, might enable the employer to take advantage of the 25 percent deduction limit for certain taxable years by making contributions for two different plan years within that taxable year.

EXAMPLE 8-10. Two Plan Years' Deductions in One Tax Year. A corporation maintains a profit sharing plan with a calendar plan year. The employer's taxable year ends June 30. The aggregate compensation of the plan participants for the taxable year ending June 30, 2018, is $1,000,000, yielding a deduction limit of $250,000. For the 2017 calendar plan year, the employer wants to make a discretionary contribution of $170,000 to the profit sharing plan, which it contributes on February 1, 2018. The employer will deduct the contribution for its taxable year ending June 30, 2018. [Alternatively, the employer could deduct the contribution for the taxable year ending June 30, 2017, if the February 1, 2018, contribution is paid before the tax return due date (including extensions) for that taxable year.]

The employer also makes a contribution on December 1, 2018, in the amount of $80,000, which the plan allocates for the plan year ending December 31, 2018. The due date for filing the employer's federal tax return for the taxable year ending June 30, 2018, is on extension to March 15, 2019. Because the December 1, 2018, contribution is made before the due date of the June 30, 2018, tax return, it too may be deducted for that taxable year, so long as the 25 percent deduction limit is not exceeded.[11] The sum of the two contributions made in 2018 is $250,000 ($170,000 made on February 1, 2018, and $80,000 made on December 1, 2018). This total amount may be deducted in full for the taxable year ending June 30, 2018, because it does not exceed 25 percent of aggregate participant compensation for that taxable year. This is true even though part of the deductible contribution for the June 30, 2018, taxable year is being allocated for the 2017 plan year and the rest is being allocated for the 2018 plan year.

Participants' Compensation Included in Deduction Limit

The deduction limit is based on the compensation of the "beneficiaries under [the plan]."[12] Who are the beneficiaries for this purpose? The IRS interprets **beneficiaries** in this context to mean employees who benefit under the plan with respect to the employer's contribution. An employee who has an account balance, and shares in trust earnings, but does not share in the allocation of the employer's contribution, is not a beneficiary of the plan for this purpose.[13]

The coverage regulations define whether an employee is benefiting under the plan for coverage purposes.[14] As a general rule, an employee must share in the allocation of an employer contribution (or forfeitures allocated in the same manner as employer contributions) to be treated as benefiting. In some cases, however, an employee is treated as benefiting for coverage purposes even though he or she does not share in the allocation of employer contributions.

If You're Curious . . .

Consider the differences in the rules for determining who is benefiting under a 401(k) arrangement, as opposed to a profit sharing plan. An employee who is eligible to defer under a 401(k) arrangement is treated as benefiting under that arrangement, even if he or she elects not to defer.[15] The IRS has stated informally on several occasions, including ASPPA's Annual Conference Q&A Sessions, that the compensation of an employee who is eligible to defer but not to receive an allocation of employer contributions should be included in determining the deduction limit for such year. However, in a 2012 private letter ruling, IRS rejected the applicant's contention that the term "beneficiary" for deduction purposes means anyone who is considered to be benefiting under the 401(k) plan for coverage testing (i.e., IRC §410(b)(6)(E), under which anyone who is eligible to defer is considered to benefit from the plan). Instead, the IRS's position in the ruling was that, because the deduction for the 401(k) funds is determined under a different section of the IRC, a participant needed to be eligible to receive an employer contribution other than pre-tax elective contributions to be included as a "beneficiary" for deduction purposes under IRC §404(a)(3).[16] While a private letter ruling is not binding on the IRS as precedent, except in relation to the specific applicant, those who are including compensation of 401(k)-only participants in the IRC §404(a)(3) deduction limitation should be on alert that this may be problematic if the plan is audited by the IRS.

The top-heavy rules require a top-heavy defined contribution plan to guarantee a minimum level of

[11] IRC §404(a)(6).
[12] IRC §404(a)(3).
[13] Rev. Rul. 65-295, 1965-2 C.B. 148.
[14] Treas. Reg. §1.410(b)-3.
[15] Treas. Reg. §1.410(b)-3.
[16] (PLR) 201229012.

contributions to certain non-key employees (generally 3 percent of compensation).[17] An employee might receive an allocation that is less than the normal profit sharing allocation for eligible participants, but equal to the minimum allocation required by the top-heavy rules. Such employee is a beneficiary of the plan for deduction purposes and his or her compensation for the employer's taxable year would be included in determining the employer's deduction limit. By including the employee's compensation in the deduction limit calculation, a larger deductible employer contribution may be supported even though that employee's allocation is limited to the top-heavy minimum allocation. In effect, that employee's compensation is supporting a larger deductible contribution on behalf of other eligible participants in the plan.

EXAMPLE 8-11. Profit Sharing Plan With No 401(k) Arrangement. A corporation maintains a profit sharing plan. To receive an allocation of employer contributions, a participant must be employed at the end of the plan year. The plan year and the corporation's taxable year is the calendar year. There are ten participants in the plan, with total compensation of $500,000. If all participants are eligible to share in the allocation, the deduction limit would be 25 percent of $500,000, or $125,000.

EXAMPLE 8-12. Participant Terminates During Year. One of the ten participants, Jeremiah, who earns $30,000, leaves during the year and does not share in the allocation. The deduction limit is now 25 percent of $470,000, or $117,500, because Jeremiah's compensation cannot be included in the calculation.

EXAMPLE 8-13. Participant's Hours Are Not Sufficient to Share in Allocation of Employer Contribution. Suppose the plan requires 1,000 hours of service and employment on the last day of the plan year to receive a contribution allocation. Jeremiah is employed at the end of the plan year, but he completes only 800 hours of service during the year. The deduction limit is $117,500, the same as the limit computed in EXAMPLE 8-12, because Jeremiah's compensation is excluded from the calculation. However, if the plan was top-heavy, Jeremiah would be eligible for a top-heavy minimum contribution, and his compensation would be included in the deductible limit.

EXAMPLE 8-14. Employee is Eligible for 401(k) Arrangement. A 401(k) plan has 50 participants. All 50 participants defer under the 401(k) arrangement. The employer also makes discretionary contributions that are allocated under a pro rata allocation method based on compensation. A participant must be employed on the last day of the plan year to share in the allocation of the discretionary contribution for that year. Only 42 of the participants are eligible for the discretionary contribution allocation. If the plan sponsor relied on the position taken by the IRS in the private letter ruling discussed previously, only the compensation of the 42 participants eligible for the discretionary contribution would be included in the determination of the deductible limit under IRC §404(a)(3). However, if the plan sponsor wanted to take a more aggressive stance, ignoring the private letter ruling that is binding only on the taxpayer that requested it, it could use the compensation of all 50 participants who benefit in the plan to determine the deductible limit.

EXAMPLE 8-15. Participant Does Not Defer Under 401(k) Arrangement Nor Share in Allocation of Employer Contribution. Suppose in the prior **EXAMPLE 8-14** that two participants,

[17] IRC §416(c).

Michele and Elaine, elect not to defer under the 401(k) arrangement. Michele also does not share in the allocation of the employer's discretionary contribution because she leaves during the plan year. Elaine shares in the allocation of the employer's contribution. Clearly, Elaine's compensation may be included in computing the deduction limit because she shares in the allocation of the employer's discretionary contribution. As was discussed in EXAMPLE 8-14, because Michele is not eligible to share in the employer discretionary contribution, a conservative plan sponsor would exclude her compensation from the determination of the deductible limit. Whether Elaine and Michele actually defer under the 401(k) section of the plan is not the relevant issue in determining whether their compensation is included in the deduction limit determination. The issue, per the private letter ruling, is whether they are eligible to share in the employer contribution.

Vested Status of Participants Has No Bearing on This Issue

If a participant is benefiting from the employer contributions, the participant's compensation is included in the deduction limit calculation, regardless of the participant's vesting status, and even if the participant is zero percent vested. This holds true even if, when the contribution is made, the participant has already terminated employment and will forfeit the contribution being allocated.

EXAMPLE 8-16. Inclusion of Terminated Employee as Beneficiary for Deduction Purposes. An employer makes a profit sharing contribution for its taxable year ending December 31, 2017. The contribution is made on March 1, 2018, and is designated for allocation for the plan year ending December 31, 2017. Among the participants who will share in the 2017 plan year allocation is Lucinda, who terminated employment in November 2017 (the plan does not require last-day employment as a condition to share in the allocation of employer contributions). Lucinda is zero percent vested and, under the plan's deemed cash-out provision, will forfeit her entire account balance, including her share of the March 1, 2018, contribution in the year in which she has a break in service (probably 2018). For purposes of coverage testing, Lucinda is considered to be benefiting for the 2017 plan year because she will share in the allocation of employer contributions. Thus, under the principles previously discussed, Lucinda's 2017 compensation is taken into account in computing the employer's 2017 deduction limit.

All Defined Contribution Plans Treated as Single Plan

All defined contribution plans maintained by the employer are treated as a single plan in computing the deduction limit.[18] For example, if the employer maintains two profit sharing plans, the total contributions to both plans for any taxable year are combined in determining whether the deduction limit has been exceeded. The aggregate compensation of the employees who are participants in either plan is taken into account in computing the combined limit.

The combined limit applies even if there are no employees who participate in both plans (i.e., each plan benefits a different segment of the employer's work force). The same rules apply if the employer maintains both a profit sharing plan and a money purchase plan (or a target benefit plan).

EXAMPLE 8-17. More Than 25 Percent Contributed to One of Two Profit Sharing Plans Covering Different Groups of Participants. Law Firm K sponsors two separate profit sharing plans, both with 401(k) arrangements. One plan covers only associates (as defined by the plan), and is labeled the Associates Plan. The other plan covers all other employees, and is labeled the Profit Sharing Plan.

[18] IRC §404(a)(3)(A)(iv).

The Profit Sharing Plan and the Associates Plan both permit Law Firm K to make discretionary profit sharing contributions. Participation in the plans is mutually exclusive.

Law Firm K's annual contribution rate to the Associates Plan currently is less than 10 percent of the total compensation of the participants in the plan. The contribution rate to the Profit Sharing Plan is close to 30 percent of the aggregate compensation of all the participants in that plan.

Law Firm K's 25 percent deduction limit is computed by combining the compensation of all participants in both plans, even though each plan covers a separate group of employees. A contribution to the Profit Sharing Plan that exceeds 25 percent of the total compensation of the participants in that plan is deductible if the combined contribution to both plans does not exceed 25 percent of the total compensation of the participants in both plans.

EXAMPLE 8-18. Two Profit Sharing Plans Covering Same Employees. An employer maintains a 401(k) plan with a matching contribution. A significant percentage of the eligible participants have high elective contribution rates (in the 15 percent to 25 percent range). The total amount of matching contributions for the taxable year is 12 percent of aggregate participant compensation. The employer would like to make deductible contributions in the form of a discretionary profit sharing contribution, and would like those contributions to equal 15 percent to 20 percent of participant payroll. The 25 percent deduction limit would allow a deductible contribution of only 13 percent of aggregate participant compensation because the matching contributions equal 12 percent. [The 401(k) elective contributions do not affect these calculations, because they are separately deductible.[19]]

The establishment of a second profit sharing plan covering the same employees would not permit the employer to make a greater deductible contribution, because that second profit sharing plan would be aggregated with the 401(k) plan under the 25 percent deduction limit and there is no additional participant compensation to take into account to increase that 25 percent limit.

Adding a separate money purchase plan also will not help, because money purchase plans are included in the IRC §404(a)(3) limit.

EXAMPLE 8-19. Separate 401(k) Plan With More Liberal Eligibility Requirements. A company maintains two profit sharing plans. The first, a profit sharing plan without a 401(k) arrangement, covers only employees who have completed at least one year of service with the company. The other, a 401(k) plan under which the employer contributes only the eligible participants' elective contributions and matching contributions, has immediate eligibility. The aggregate compensation of all employees for the taxable year is $10,000,000. The aggregate compensation of those employees who also benefit under the profit sharing plan is $8,000,000. Because all of the employees are eligible for the 401(k) plan, the deduction limit for the combined contribution to both plans is $2,500,000 (i.e., 25 percent of $10,000,000). Note that the $8,000,000 of compensation paid to the employees who benefit under the profit sharing plan is not added to the $10,000,000 to calculate the deduction limit because those employees' aggregate compensation is already included in the $10,000,000.

No Credits in Future Years

The deduction limit is applicable only in the year to which it applies, meaning an additional deductible contribution cannot be made in later years to make up for underutilization of the limit in earlier years.

EXAMPLE 8-20. Unused Deduction in One Year Does Not Roll Over to the Following Year.

[19] IRC §404(n).

Corporation K maintains a profit sharing plan. For the employer's taxable year, the aggregate compensation of all participants is $400,000. The 25 percent deduction limit is $100,000. Corporation K contributes $55,000. The unused portion of the deduction limit ($45,000) is not carried over to increase the deduction limit for the following year.

Carryforward of Deduction for Overcontribution

If the deduction limit is exceeded for a taxable year, the excess amount is carried forward and may be deducted in the succeeding taxable year.[20] The carryforward is charged against the deduction limit in that succeeding year.

EXAMPLE 8-21. Nondeductible Amount Carried Forward to Following Year. Corporation F maintains a profit sharing plan. The plan year and Corporation F's taxable year are the calendar year. For the 2018 taxable year, aggregate participant compensation is $1,000,000. Corporation F contributes $275,000 for the 2018 taxable year. The deduction limit for 2018 is 25% x $1,000,000, or $250,000. The deduction limit of $250,000 is exceeded by $25,000. The nondeductible amount ($25,000) is treated as part of Corporation F's 2019 contribution for allocation purposes (i.e., the entire $275,000 that was contributed is allocated for 2018, even though only $250,000 was deductible).

For 2019, the aggregate participant compensation is $1,100,000. The deduction limit for 2019 is 25% x $1,100,000, or $275,000. Because the $25,000 nondeductible contribution from 2018 was carried over to 2019 for deduction purposes, Corporation F may contribute and deduct no more than $250,000 for 2019.

Administrative Treatment of Nondeductible Contribution

An employer contribution is still allocable to the plan participants, regardless of whether it is currently deductible. The fact that the contribution exceeds the deduction limit does not mean the nondeductible amount can be refunded to the employer. The timing of contributions and the consequences of making nondeductible contributions are discussed later in this chapter.

Contributions Made During Plan Year

If the contribution is made during the plan year, it must be allocated to the participants to the extent it does not exceed the limits under IRC §415. Amounts cannot be held unallocated merely because they are not currently deductible. Contributions may be allocated to a suspense account only when specifically authorized.[21] In addition, failure to allocate the contribution would be a failure to follow the terms of the plan, which is a qualification requirement. In these circumstances, the year in which the nondeductible portion of the contribution is allocated is different from the year in which it is deducted by the employer.

Contributions Made After Close of Plan Year

If the employer's contribution is made after the close of the plan year, the nondeductible portion may be designated as a contribution for the next year to the extent such designation is not contrary to the contribution formula under the plan. (Note that for a money purchase plan, the contribution requirement is fixed by the plan, so the amount needed to satisfy the funding requirement will usually dictate the year to which the contribution needs to be allocated.)

EXAMPLE 8-22. Designation of Contributions Made After Year End. Corporation T maintains a profit sharing plan. The contribution formula is discretionary. The plan year and Corporation T's

[20] IRC §404(a)(3)(A)(ii).

[21] Rev. Rul. 80-155, 1980-1 C.B. 84.

taxable year are the calendar year. The combined participant compensation for 2018 is $500,000, and the deduction limit is $125,000. On February 1, 2019, Corporation T contributes $160,000 to the profit sharing plan. Because the contribution formula is discretionary, Corporation T may designate $125,000 as the contribution for 2018, and treat the rest of the contribution ($35,000) as made for 2019.

If You're Curious . . .

Deduction of Carryforwards After Plan Terminates

What if the defined contribution plan terminates while nondeductible carryforwards from prior years remain unabsorbed? Treas. Reg. §1.404(a)-9(b)(2) provides a rule for deducting such contributions in taxable years following the termination of the plan. Under the regulation, the deduction limit for any taxable year following the termination of the plan is computed by taking into account the compensation of the employees who were benefiting under the plan at any time during the one-year period ending on the last day of the calendar month in which the plan was terminated.

EXAMPLE 8-23. Deductions After Plan Termination. For the plan year ending December 31, 2017, an employer contributed to its profit sharing plan $23,000 more than what was deductible under the deduction limit. The plan was terminated as of December 31, 2017. The nondeductible contribution of $23,000 was allocated to the participants for the 2017 plan year as part of the final allocations of the terminated plan. (IRC §415 limits were not exceeded by the allocation.) The employer may deduct the $23,000 contribution for its 2018 taxable year. To determine the 25 percent deduction limit, the compensation of the participants for the 2017 plan year (i.e., the 12-month period ending with the month in which the plan terminated) is used. That compensation was $400,000, supporting a deduction of $100,000. Because the $23,000 nondeductible contribution from 2017 is less than $100,000, it is fully deductible for 2018.

Special Issues for Money Purchase Plans

The employer's funding liability to a money purchase plan (including a target benefit plan) is affected by the plan's contribution formula, and is enforceable under the minimum funding requirements of IRC §412. Nonetheless, the employer's contributions to such plans are subject to the same deduction limit as that for profit sharing plans. There is no exception to the 25 percent deduction limit, even if the minimum funding requirements applicable due to the plan's contribution formula cause the employer to exceed the 25 percent limit. Thus, an employer that sponsors a money purchase plan or target benefit plan should consider document language that limits the contribution to no more than 25 percent of aggregate participant compensation, or setting limits on the amount that may be funded for particular individuals, to ensure that the 25 percent aggregate limit is not exceeded. This is particularly important in a target benefit plan where, because of a participant's advanced age, the required contribution might be well in excess of 25 percent of compensation.

If the employer maintains nonpension plans in addition to the money purchase plan or target benefit plan, the contributions under those plans also need to be taken into account for deductibility. The issue raised here may be eliminated by no longer maintaining money purchase plans or target benefit plans. As noted earlier in the text, the 25 percent deduction limit applies whether the employer maintains only nonpension plans, such as profit sharing plans or stock bonus plans, or a combination of pension plans (e.g., money purchase plans) and nonpension plans (e.g., profit sharing plans).

EXAMPLE 8-24. Money Purchase Plan Covering Only One Participant. A money purchase plan covers only one participant. The plan year is the calendar year. The sole participant's com-

pensation for the 2018 plan year is $132,000. The employer's taxable year also is a calendar year. The IRC §415 limit in effect for 2018 is the lesser of 100 percent of compensation or $55,000. Assuming there is no other plan, the money purchase formula would have to be 41.67 percent of compensation to reach the participant's $55,000 IRC §415 limit. However, if the plan is designed that way, a portion of the contribution would not be deductible for 2018. The deduction limit for 2018 is 25 percent x $132,000, or $33,000, because the defined contribution deduction limit applies to money purchase plans. This is an illustration of why money purchase plans are less popular in post-EGTRRA years. After EGTRRA, a 401(k) plan can enable the participant to reach the IRC §415 limit through the use of elective contributions.

Treatment of Forfeitures

Forfeitures allocated under a profit sharing plan do not reduce the employer's defined contribution deduction limit. In a discretionary contribution plan, this is true even if the plan provides that forfeitures reduce employer contributions. Thus, the employer may still contribute an amount up to the full 25 percent deduction limit under a discretionary profit sharing plan, even though forfeitures are allocated for the plan year.

Note that the employer is not entitled to deduct the forfeitures as if they were part of its contribution to the plan. Only amounts added to the trust for a taxable year are eligible for deduction by the employer. Forfeitures represent benefits that are reallocated from one participant's account (i.e., the person forfeiting the benefit) to the accounts of the other participants. Thus, the employer already received a deduction for the amounts that generated the forfeiture in a prior plan year. Also note that forfeitures are annual additions under IRC §415, so the allocation of forfeitures is counted in determining whether the plan has exceeded the IRC §415 limits with respect to a participant.

If a defined contribution plan provides for a fixed contribution formula, the allocation of forfeitures might reduce the amount that the employer contributes. In such a case, the employer's deduction for that year will be diminished, because the employer may contribute only the amount permitted under the plan's contribution formula, unless the plan also authorizes an additional discretionary contribution (which would not be permissible if the plan is a money purchase plan or target benefit plan). Therefore, if the contribution required by the plan falls short of using up the full deduction limit, the employer would be violating the terms of the plan to contribute an additional amount, unless the plan permits such additional contribution (or the plan was amended on a timely basis to provide for such additional contribution).

OVERALL DEDUCTION LIMIT FOR CERTAIN OVERLAPPING PLANS

If the employer maintains certain overlapping plans, an overall deduction limit applies under IRC §404(a)(7). An **overlapping plan** situation occurs when an employer maintains at least one defined contribution plan and at least one defined benefit plan, and at least one employee participates in both plans.[22] Multiple sets of overlapping plans are taken together to compute this limit.[23]

The overall deduction limit for overlapping plans is generally 25 percent of the aggregate compensation of all participants under the overlapping plans. However, the overlapping plan limit is never less than the minimum funding requirement under IRC §412 with respect to a defined benefit plan included in the calculation. So, even if such minimum funding requirement is greater than the 25 percent limit, contributions to the defined benefit plan that exceed such amount but are within the minimum funding requirement are deductible.

Furthermore, for post-PPA years (i.e., plan years beginning on or after January 1, 2006), the 25 percent limit only applies if employer contributions to the defined contribution plan exceed 6 percent of compensation. Also, for years

[22] IRC §404(a)(7)(C)(I).

[23] Treas. Reg. §1.404(a)-13 and PLR 200346024.

beginning on or after January 1, 2008, the 25 percent limit does not apply if the defined benefit plan is covered by the PBGC.[24]

In other words, the deduction limit for overlapping plans is generally limited to the greater of:

- 25 percent of compensation plus up to 6 percent of compensation to the defined contribution plan (i.e., 31 percent, if 6 percent is contributed to the defined contribution plan); or
- The amount necessary to meet defined benefit plan's minimum funding requirement for the year, plus a contribution of 6 percent of compensation to the defined contribution plan.

When determining the minimum funding requirement under the defined benefit plan, the plan year ending in the taxable year is used, even if the defined benefit plan uses a different method to compute its individual deduction limit under IRC §404(a)(1).

In addition to the previously mentioned permitted deductions, elective contributions to a 401(k) plan are fully deductible, without regard to the 25 percent limit. This is because they are separately deductible.[25]

Compensation for Overlapping Plan Deduction Limit Purposes

The definition of compensation taken into account under the 25 percent limit is the same as the compensation used for the defined contribution deduction limit.[26] The compensation definition includes the same elective contributions as are included for purposes of IRC §415.[27]

Treatment of Elective Contributions under a 401(k) Plan

Elective contributions made under a 401(k) plan are separately deductible and are not taken into account to determine whether the employer's contributions in the overlapping plans are in excess of the IRC §404(a)(7) limit.[28] However, if the 401(k) plan provides for any matching contributions or nonelective contributions, the overlapping plan limit would apply to those contributions if that plan covers at least one employee who also participates in the defined benefit plan.

A one-person 401(k) plan may be maintained with a one-person defined benefit plan and not be subject to the overlapping plan limit, so long as the only contributions made to the 401(k) plan are the elective contributions and an amount of matching or nonelective contribution that does not exceed 6 percent of compensation.

Catch-up contributions are elective contributions, too, so the fact that a participant's elective contributions include catch-up contributions would not affect the full deductibility of the elective contributions and the 6 percent contribution to the defined contribution plan, in addition to the defined benefit plan funding.

Overlapping Plan Situations Subject to the IRC §404(a)(7) Deduction Limit

An overlapping plan situation usually means that the special deduction limit under IRC §404(a)(7) is applicable. If there is an overlapping plan situation between a defined benefit plan and a defined contribution plan, but for the taxable year the only contributions made under the defined contribution plan are elective contributions under a 401(k) arrangement and/or a 6 percent matching or nonelective contribution, the overlapping plan limit does not apply.[29]

EXAMPLE 8-25. Overlapping Participants in a 401(k) Plan and a Defined Benefit Plan; 6 Percent Cushion Not Exceeded. Corporation T maintains a 401(k) plan and a defined benefit plan. The com-

[24] IRC §404(a)(7)(C)(iv).
[25] See, IRC §§404(a)(7)(C)(ii), 404(n).
[26] Treas. Reg. §1.404(a)-13(a).
[27] IRC §404(a)(12).
[28] IRC §404(n).
[29] IRC §404(a)(7)(C)(ii).

bined compensation of all participants in both plans is $1,000,000. The minimum funding required under the defined benefit plan is $200,000. The 25 percent limit under the overlapping plan rules is 25% x $1,000,000, or $250,000.

Because the minimum funding requirement under the defined benefit plan is $200,000, only $50,000 of the 25 percent limit remains for employer contributions to the 401(k) plan. However, before this limit applies, the defined contribution plan employer contribution must exceed the 6 percent cushion ($60,000).

The employer contributes $120,000 in elective contributions and $60,000 of matching contributions. Elective contributions are not subject to the IRC §404(a)(7) limit, so they may be disregarded.

Because the $60,000 employer contribution equals the 6 percent cushion, the 25 percent limit applies to neither the defined benefit plan nor the 401(k) plan. All three amounts (the defined benefit funding amount of $200,000, the employer matching contribution of $60,000 and the elective contributions of $120,000) are deductible.

EXAMPLE 8-26. Overlapping Participants in a 401(k) Plan and a Defined Benefit Plan; 6 Percent Cushion Exceeded But Still Within IRC §404(A)(7) Limit. Suppose that Corporation T from EXAMPLE 8-25 contributed an additional $25,000 in nonelective contributions, bringing the total contribution to the 401(k) up to $205,000:

Elective contributions	$120,000
Matching contributions	$60,000
Nonelective contributions	$25,000
Total 401(k) plan contributions	$205,000

Now the total of the two employer contributions is $85,000. That exceeds the 6 percent cushion of $60,000, so IRC §404(a)(7) applies.

The 25 percent limit of $250,000 is applied to the total of the defined benefit contribution ($200,000) and the defined contribution employer contribution in excess of the 6 percent cushion ($85,000 - $60,000 cushion = $25,000).

25 percent limit	$250,000
Defined benefit minimum funding	($200,000)
Remaining available deduction	$50,000
Contributions in excess of 6 percent	($25,000)
Remaining available deduction	$25,000

Because the minimum funding requirement under the defined benefit plan is $200,000, $50,000 of the 25 percent limit remains for employer contributions to the 401(k) plan. Because the defined contribution plan employer contribution in excess of the 6 percent cushion ($85,000 - $60,000 = $25,000) is less than the $50,000 limit, it is fully deductible under IRC §404(a)(7).

Another way to look at this is Corporation T may deduct up to the 25 percent limit of $250,000, plus an additional 6 percent to the defined contribution plan, or a total of 31 percent of compensation. 31 percent of $1,000,000 (the combined compensation of all participants in both plans) is $310,000. The defined benefit contribution of $200,000, plus $85,000 in employer contributions to the defined contribution plan does not exceed $310,000, thus, the contributions are fully deductible under IRC §404(a)(7). Note, however, that 6 percent of the 31 percent total must be contributed to the defined contribution plan in order for this calculation to satisfy IRC §404(a)(7).

EXAMPLE 8-27. Overlapping Participants in a 401(k) Plan and a Defined Benefit Plan; 6 Percent Cushion and IRC §404(A)(7) Limit Exceeded. Suppose that Corporation T from EXAMPLE 8-26

contributed $60,000 in nonelective contributions, rather than $25,000. This would bring the total contribution to the 401(k) up to $240,000:

Elective contributions	$120,000
Matching contributions	$60,000
Nonelective contributions	$60,000
Total 401(k) plan contributions	$240,000

The total of the two employer contributions is now $120,000. That exceeds the 6 percent cushion of $60,000, so IRC §404(a)(7) applies.

The 25 percent limit of $250,000 is applied to the total of the defined benefit contribution ($200,000) and the defined contribution employer contribution in excess of the 6 percent cushion ($120,000 - $60,000 cushion = $60,000).

25 percent limit	$250,000
Defined benefit minimum funding	($200,000)
Remaining available deduction	$50,000
Contributions in excess of 6 percent	($60,000)
Contributions in excess of deduction limit	($10,000)

Because the minimum funding requirement under the defined benefit plan is $200,000, $50,000 of the 25 percent limit remains for employer contributions to the 401(k) plan. Because the defined contribution plan employer contribution in excess of the 6 percent cushion ($120,000 - $60,000 = $60,000) is greater than $50,000, it exceeds the limit under IRC §404(a)(7) by $10,000. Therefore, only $50,000 is deductible, and the $10,000 balance is carried forward to be deducted in later years.

The deduction limit (25 percent of aggregate compensation) is shared by the defined benefit plan and the defined contribution plan, so each dollar of the defined benefit plan contribution reduces the maximum limit available under the 401(k) plan in excess of 6 percent of compensation.

EXAMPLE 8-28. DB Minimum Funding Exceeds 25 Percent Limit. Suppose in **EXAMPLE 8-25** that the minimum funding requirement under the defined benefit plan is $400,000. Only the 6 percent matching or nonelective contribution can be made to the 401(k) plan and deducted for such year [in addition to the 401(k) elective contributions] because the minimum funding requirement under the defined benefit plan exceeds the 25 percent limit. The defined benefit plan contribution also is still deductible because the overlapping plan limit is the greater of the minimum funding amount under the defined benefit plan or the 25 percent limit.

EXAMPLE 8-29. Overlapping Participants in a DB Plan and Money Purchase Plan. Corporation N maintains a 10 percent money purchase plan and a defined benefit plan with overlapping participants. Although both plans are pension plans that are subject to the minimum funding requirements, the overlapping plan deduction limit applies because one plan is a defined contribution plan and one plan is a defined benefit plan. The combined compensation of all participants in the two plans is $800,000. The 25 percent limit is $200,000. The required money purchase contribution is $80,000 ($800,000 x 10%). The minimum funding requirement under the defined benefit plan is $175,000. The combined contribution is $255,000, which exceeds the 25 percent limit. Only the defined benefit contribution of $175,000 plus 6 percent of compensation in the money purchase plan ($48,000) is deductible. The remaining $32,000 of money purchase plan contribution is carried forward to succeeding taxable years for deduction purposes.

It is critical in this analysis to know when to use the compensation of the defined contribution plan participants and

when to use the compensation of all participants in the IRC §404(a)(7) group. When applying the 25 percent limit under §404(a)(7), the total compensation of all eligible participants in both the defined benefit and defined contribution plans is used. However, when determining the deduction limit in the defined contribution plan by itself or the 6 percent deduction that is permitted for that plan before the IRC §404(a)(7) limit is invoked, the compensation used is that of the participants in the defined contribution plan only.

In **EXAMPLE 8-29**, the entire money purchase contribution is still allocated for the current year because it is required under the plan's contribution formula. The fact that it is not fully deductible in the current year does not affect the timing of the allocation.

As you can see from **EXAMPLE 8-29**, IRC §404(a)(7) only guarantees that minimum funding under a defined benefit plan and a 6 percent contribution to a defined contribution plan is deductible without regard to the 25 percent limit. As previously illustrated, this may leave the employer with a required, but nondeductible, contribution to a money purchase plan. To cure this problem, the money purchase plan may be drafted to limit the required contribution to the amount deductible under the §404(a)(7) overlapping plan deduction limits. Such a plan provision does not cause the money purchase plan to fail the definitely determinable benefits requirement for pension plans.[30]

Summary of Combined Plan Limits for Plans Subject to the IRC §404(a)(7) Deduction Limit

For plans that are covered under IRC §404(a)(7), the deductible limit for both plans combined is limited to the greater of:

- 25 percent of compensation of the combined §404(a)(7) group, plus up to 6 percent of the defined contribution plan participants' compensation to be contributed to the defined contribution plan (in other words, 31 percent if 6 percent is contributed to the defined contribution plan and the same participants are in both the defined benefit and the defined contribution plans); or
- The amount necessary to meet defined benefit plan's minimum funding requirement for year, plus a contribution of 6 percent of compensation of the participants in the defined contribution plan to the defined contribution plan.

Remember that elective contributions under a 401(k) plan are separately deductible and are not taken into account to determine whether the employer's contributions in the overlapping plans are in excess of the IRC §404(a)(7) limit.

The defined benefit plan maximum is also subject to the maximum tax deductible amount based on the rules for a stand-alone defined benefit plan.

If You're Curious…

How Is it Determined Whether an Employee Is an Overlapping Participant?

IRC §404(a)(7) refers to the compensation of the beneficiaries under the plans involved, and IRC §404(a)(7)(C)(i) outlines how to determine who is an overlapping beneficiary. In the absence of guidance to the contrary, it is presumed that the coverage regulations under IRC §410(b) are appropriate for determining whether an employee is a beneficiary under the plans involved in IRC §404(a)(7).[31] This is the same approach taken for purposes of the 25 percent deduction limit for defined contribution plans under IRC §404(a)(3), because that section also makes reference to the beneficiaries of the plan.

Who's included in the group of beneficiaries is determined based on whether the plan sponsor is conservative or aggressive in its approach. As discussed in Section 1.03[B]6, the IRS has privately ruled that the compensation total should include only amounts paid to those participants who are eligible to receive an allocation of employer contribution. A conservative approach would apply this rule, even though the ruling is binding only on the employer that requested it. A more aggressive

[30] IRC §404(a)(7)(A) (last paragraph).

[31] Treas. Reg. §1.410(b)-3.

approach may apply the definition of "benefiting" from IRC §410(b), and include compensations of anyone who is eligible for any type of contribution in the plan (i.e., including those who may make elective contributions to a 401(k) feature). An employee must have an increase in an accrued benefit to be treated as benefiting under a defined benefit plan.

Nonidentical Participation in the Plans Subject to the Limit

If some, but not all, of the participants in the plans are the same, the 25 percent overlapping plan deduction limit is calculated by taking into account the compensation of all employees who benefit under either plan, regardless of whether an employee participates in both plans or only in one of the plans.

EXAMPLE 8-30. Overlapping Plan Limit With Only Some Overlapping Participants. Employer X maintains a profit sharing plan that covers employees in Divisions A and B, and a defined benefit plan that covers employees in Divisions B and C. Because employees in Division B participate in both plans, an overlap of participants between the two plans is created, and the overlapping plan deduction limit applies. The 25 percent limit is calculated by aggregating the compensation of all participants in the two plans, whether they participate in both plans (employees of Division B) or only in one of the plans (employees of Division A and employees of Division C).

Separate Limits Cannot Be Exceeded

The overlapping plan deduction limit under IRC §404(a)(7) is an additional deduction limit and does not replace the separate deduction limits that otherwise apply to the plans involved. This overlapping plan limit is "determined and applied after all the limitations, deductions otherwise allowable, and carryforwards under section 404(a)(1), (2) and (3) have been determined and applied..."[32]

EXAMPLE 8-31. Profit Sharing Plan and Defined Benefit Plan. An employer maintains a profit sharing plan and a defined benefit plan with overlapping participants. For the taxable year, the combined compensation of the participants in the two plans is $1,000,000, so the 25 percent overlapping plan deduction limit is $250,000. The compensation of participants in just the profit sharing plan is $600,000. The normal IRC defined contribution deduction limit on the profit sharing plan is $150,000 (i.e., 25% x $600,000). The minimum funding requirement under the defined benefit plan is only $60,000, and the employer contributes that amount to the plan. Although the 25 percent limit would allow an additional contribution of $190,000 (i.e., $250,000 - $60,000), the maximum deductible contribution to the profit sharing plan is $150,000. The employer may not use the overlapping plan deduction limit as a means of exceeding the individual defined contribution plan deduction limit that applies to the profit sharing plan.

Contributions That Exceed the Limit

If the overlapping plan deduction limit is exceeded, the nondeductible amount is carried forward to the next year (and succeeding taxable years, if necessary), and applied to the overlapping plan deduction limit for such year. The nondeductible amount and contributions made for the next taxable year are combined to determine whether the limit is exceeded for that next year. Although contributions may be carried forward for deduction purposes, the treatment of the nondeductible contributions for allocation purposes is determined under the terms of the plan.

[32] Treas. Reg. §1.404(a)-13(c).

EXAMPLE 8-32. One-Person Plans. A corporation employs only the sole shareholder of the company. The corporation maintains two plans, a defined benefit plan and a profit sharing plan. The shareholder is the only participant in both plans. The shareholder's annual compensation for the 2018 taxable year is $230,000. The 25 percent overlapping plan deduction limit under IRC §404(a)(7) is 25% x $230,000, or $57,500. If the deductible contribution under the defined benefit plan for that year equals or exceeds $57,500, a deduction will be permitted for that year with respect to the profit sharing plan of up to 6 percent of compensation.

However, if the deductible contribution to the defined benefit plan is less than $57,500, the deduction limit for the profit sharing contribution is the total of:

a. the difference between $57,500 and the amount of the defined benefit plan deduction and
b. 6 percent of compensation.

If the profit sharing plan includes a 401(k) arrangement, the elective contributions [including catch-up contributions under IRC §414(v)] are deductible in full, without regard to the 25 percent limit, so long as the total annual additions under the profit sharing plan do not cause the individual to exceed his IRC §415(c) limit for that year. The elective contributions under the 401(k) arrangement (other than the catch-up contributions) would be taken into account to determine if the annual additions limit under IRC §415(c) is exceeded. Any amount in excess of these limits will not be deductible in 2018, but may be carried forward and deducted in 2019.

EXAMPLE 8-33. More Than One Participant. Suppose the corporation in the prior **EXAMPLE 8-32** has ten other employees, all of whom are eligible for both plans. The combined compensation of all participants (including the shareholder's compensation) is $600,000. Now the 25 percent overlapping plan deduction limit under IRC §404(a)(7) is $150,000. There will be room for a profit sharing plan deduction in excess of 6 percent of compensation for a taxable year so long as the defined benefit plan deduction for that year is less than $150,000. Thus, if the deductible defined benefit contribution is $85,000, there is room for a deductible profit sharing contribution of 6 percent of compensation plus $65,000 (i.e., $150,000 - $85,000). Any excess amount will not be deductible in 2018, but can be carried forward to 2019.

TIMING OF CONTRIBUTION

Contributions may be deducted by the employer for a prior taxable year if actual payment is made on or before the due date (including extensions) for filing the employer's federal tax return for such year.[33] This rule applies to both cash basis and accrual basis taxpayers.[34] Thus, even if the accrual basis taxpayer incurs a liability to fund the plan, the failure to make the actual contribution before the tax return due date (including extensions) precludes deduction of the contribution for the taxable year for which the tax return was already due.

To qualify for a deduction in the prior taxable year, a contribution that is made after the close of the taxable year must be treated by the plan in the same manner as a contribution that would have been paid to the plan on the last day of that taxable year.[35]

If the plan year is the same period as the taxable year, to qualify for a deduction in the prior taxable year for a contribution that is made after the close of that year, the contribution must be allocated for the plan year that coincides with that prior taxable year.

[33] IRC §404(a)(6).
[34] Treas. Reg. §1.404(a)-1(c); Don E. Williams Co. v. Commissioner, 429 U.S. 569 (1977) (which held that the absence of any language in IRC §404 referring to the accrual of the contribution liability "indicates [a] congressional intent to permit deductions for . . . plan contributions only to the extent they are actually paid and not merely accrued or incurred during the year").
[35] Rev. Rul. 76-28, 1976-1 C.B. 106.

EXAMPLE 8-34. Plan Year Same as Tax Year. A corporation maintains a profit sharing plan with a plan year ending December 31. The corporation's taxable year also ends December 31. On March 1, 2018, the corporation makes a discretionary contribution to the profit sharing plan in the amount of $51,000. Because the contribution date is before the due date of the return for the taxable year ending December 31, 2017, it may be deducted for that year, but only if the contribution is allocated for the plan year ending December 31, 2017. If the employer designates the contribution (or part of the contribution) for the 2018 plan year, then the contribution (or the portion of the contribution so designated) would not be deductible for the 2017 taxable year, but would be deductible in 2018.

Plan Year Different from the Taxable Year

If the employer's plan year is different from the taxable year, the last day of the taxable year will not coincide with the last day of a plan year, so there may be more flexibility in choosing the plan year for which the allocation may be made under a nonpension plan.

Required Contributions

If the contributions are made under a fixed formula (e.g., a profit sharing plan requires the employer to contribute 3 percent of compensation or 10 percent of the employer's net profits), if the contributions represent the employees' elective contributions under a 401(k) arrangement or if the contributions are matching contributions required by the plan, then the contributions will be allocated for the plan year for which the contributions are made. For example, if a required contribution for the plan year ending December 31, 2018, had not been funded yet, a contribution made on September 1, 2019, would be allocated for the 2018 plan year to satisfy that contribution liability.

Money Purchase Plans

The year for which contributions are allocated under a money purchase plan is also affected by the contribution formula in the plan, and the plan year to which a contribution relates under the minimum funding requirements. Note, however, that even minimum funding contributions under money purchase plans are subject to the same deduction limit that applies to profit sharing plans and stock bonus plans.

Special Issue for Elective Contributions and Matching Contributions

For an employer to take a deduction in its prior taxable year for elective contributions and matching contributions made prior to the tax return due date (including extensions), those contributions must relate to compensation earned no later than the last day of that prior taxable year.[36]

Extensions on Tax Return

If the employer obtains an extension on its tax return, the full extension period is available for making the contribution, even if the return is actually filed before the end of that extension period.[37]

EXAMPLE 8-35. Contribution and Deduction Timing. Corporation X maintains a profit sharing plan. The plan year and Corporation X's taxable year are the calendar year. Corporation X's return for the 2017 taxable year is extended to October 15, 2018. Corporation X files its 2017 tax return on August 1, 2018, claiming a $50,000 deduction (which is within the defined contribution deduction

[36] Rev. Rul. 90-105 (as amplified by Rev. Rul. 2002-46).

[37] Rev. Rul. 66-144, 1966-1 C.B. 91. (Note that Rev. Rul. 66-144 makes reference to an accrual basis taxpayer because, at that time, IRC §404(a)(6) only applied to such taxpayers. ERISA amended IRC §404(a)(6) to expand the provision to cover cash basis taxpayers.)

limit). The contribution is not actually made until September 15, 2018. The contribution is deductible for 2017 because Corporation X makes the contribution by the extended due date of the tax return, even though the return was filed earlier.

Relevant Contribution Deadline Depends on Type of Employer

The due date for filing the employer's federal tax return (and the associated date by which contributions must be deposited for deduction purposes) depends on the type of employer.

It is important to note that corporations and limited liability companies (LLCs) taxed as corporations are subject to an earlier due date for tax return purposes than sole proprietorships, partnerships and LLCs taxed as partnerships. In addition, the length of extension available to partnerships and LLCs taxed as partnerships is shorter than for sole proprietorships, corporations and LLCs taxed as corporations.

If You're Curious . . .

If the employer is a corporation, the contribution deadline is determined with reference to the due date of the tax return (Form 1120) that is filed by the corporation for such taxable year. If the employer is a partnership, the relevant due date is for the tax return (Form 1065) filed by the partnership for such taxable year, not the individual tax returns of the individual partners. If the employer is a sole proprietorship, the relevant due date is for the tax return (Form 1040) filed by the sole proprietor. (A sole proprietor's trade or business income is reported on Schedule C of the Form 1040.) A limited liability company (LLC) will file Form 1120 or Form 1065 (or Form 1040, if there is one owner), depending on whether it has elected to be treated as a corporation or an unincorporated entity for federal tax purposes.

Some partnerships include one or more separately incorporated partners. In many cases, the partnership and these corporate partners are treated as an affiliated service group under IRC §414(m). Suppose the corporate partner is a participating employer in the partnership's plan. In that case, the corporate partner is a separately contributing employer, and the due date of that corporate partner's return for a taxable year determines the latest date that the corporate partner may make a contribution to the plan that will be deductible for that taxable year.

EXAMPLE 8-36. Partner Tax Return Due Date. Partnership Q, a medical partnership, has three partners and each partner is a professional corporation. The corporate partners are A, B and C. An affiliated service group relationship exists among Partnership Q and corporate partners A, B and C. The four entities maintain a single profit sharing plan. The taxable year for all four entities ends every December 31. For the taxable year ending December 31, 2017, corporate partner B's tax return is extended to September 15, 2018. The other entities do not have extensions on their tax returns for that taxable year. Corporate partner B may make a deductible contribution to the plan for the taxable year ending December 31, 2017, as late as the extended tax return due date of September 15, 2018.

This rule is not true for individual partners of a partnership. The employer for IRC §404 purposes is the partnership, not the partners, so an extension on an individual partner's federal tax return has no effect on the deadline for making deductible contributions for the taxable year of the partnership, even for contributions made on the partner's behalf.

EXAMPLE 8-37. Individual Partner Extends His Return. Partnership A is owned by Mathilda and Marvin. The tax return Form 1065 for the 2018 tax year is filed timely, but Marvin extends his personal tax return until October 15, 2018. The partnership must make the contribution for Marvin to the Partnership A profit sharing plan by the due date of the partnership's tax return (Form 1065), regardless of the due date of Marvin's personal return, to deduct the contribution for the 2018 tax year.

The following chart reflects the filing deadlines for calendar year entities, and is a good reference for determining appropriate contribution deadlines:

Type of Employer*	Tax Return	Filing Deadline	Extended Deadline
Corporation	Form 1120	April 15	October 15
LLC Taxed as Corporation	Form 1120	April 15	October 15
Partnership	Form 1065	March 15	September 15
LLC Taxes as Partnership	Form 1065	March 15	September 15
Sole Proprietorship	Form 1040	April 15	October 15
* Calendar year tax filer			

EXAMPLE 8-38. Corporate Plan Sponsor With no Extension on Tax Return. Corporation X maintains a money purchase plan with a plan year ending every December 31. Corporation X's taxable year also ends December 31. For the taxable year ending December 31, 2018, Corporation X does not obtain an extension on its tax return, so the return is due April 15, 2019. For Corporation X to deduct the 2018 money purchase contribution on its 2018 tax return, it must make the contribution by the deduction deadline of April 15, 2019.

If a plan sponsor contributes too late to obtain a deduction for the prior taxable year, the deductibility of the contribution in the following taxable year will be subject to the 25 percent defined contribution deduction limit for such following year under IRC §404(a)(3).

EXAMPLE 8-39. Contribution Deductible in Following Year. Corporation X makes its 2018 money purchase plan contribution after the tax return date of April 15, 2019. It can double-up on its money purchase contribution deduction for the 2019 taxable year. If the required contribution for the 2019 plan year is made by the tax return date of April 15, 2020, then the contributions for both the 2018 and 2019 plan years will be deductible for 2019. However, the total amount is deductible for the 2019 taxable year only to the extent it does not exceed the 25 percent limit for 2019. Corporation X should consider the impact this doubling-up might have on the deductibility of its 2019 plan contribution.

If You're Curious . . .

Coordination of Pension Funding Rules with Deductibility Rules

Pension plans must be funded within 8½ months of the plan year end or they violate the minimum funding standards of the IRC. If the plan year and the taxable year are the same, the minimum funding deadline coincides with the extended tax return due date for a corporation.

EXAMPLE 8-40. Corporate Sponsor With Extension on Tax Return. Corporation Z maintains a money purchase plan. Both the taxable year and the plan year are the calendar year. Corporation Z extends its tax return deadline for the 2018 taxable year to October 15, 2019. Now the deadline for making a deductible contribution for the taxable year ending December 31, 2018, is a month after the minimum funding deadline for the plan year ending December 31, 2018.

EXAMPLE 8-41. Not Deductible for the Fiscal Year, But Contributed Before Minimum Funding Deadline. Suppose Corporation Z from **EXAMPLE 8-40** did not extend its tax return, and made the contribution after March 15, 2019. To avoid failing to meet the minimum funding requirements with respect to the 2018 required contribution, Corporation Z has until September

15, 2019 (i.e., 8½ months after the close of the plan year) to make the contribution. If Corporation Z makes the contribution after March 15, 2019, but no later than September 15, 2019, it will avoid a minimum funding deficiency for the 2018 plan year, but its contribution will be deductible for the 2019 taxable year, not the 2018 taxable year.

The minimum funding deadline sometimes leads to inadvertent funding deficiencies for an unincorporated business (corporations have this issue as well) with an extended tax filing deadline that is later than the minimum funding deadline. A sole proprietor, for example, is able to extend his or her tax return up to October 15th for a taxable year ending December 31.[38] This is one month later than the 8½ month funding deadline.

EXAMPLE 8-42. Sole Proprietor With Extended Tax Return Deadline. Dr. Kendrick is an unincorporated sole proprietor. She maintains a money purchase plan that covers her and two employees. The plan year is the calendar year. Dr. Kendrick's 2018 tax return is on extension to October 15, 2019. The minimum funding deadline is September 15, 2019 (which is 8½ months after the close of the plan year). Dr. Kendrick makes the money purchase contribution on October 1, 2019. Although the contribution is timely under the deduction rules, so that it can be deducted for the 2018 taxable year, it is late for minimum funding purposes.

Taxable Year Different From Plan Year

When the taxable year is different from the plan year, the tax return deadline and the minimum funding deadline will rarely coincide. As with the sole proprietor issue previously mentioned, the employer must take care that extensions on its tax return do not inadvertently result in late contributions from a minimum funding standpoint.

EXAMPLE 8-43. Corporation's Taxable Year is Different From Plan Year. Corporation L maintains a money purchase pension plan. The plan year is the calendar year, but Corporation L's taxable year ends September 30. Deductions are calculated by Corporation L with respect to minimum funding for the plan year ending in the taxable year. For the plan year ending December 31, 2018, the minimum funding is $50,000. Corporation L makes the contribution on November 1, 2019, which is within the normal due date for the tax return relating to the September 30, 2019, taxable year (regular tax return deadline is January 15, 2020). Although the contribution is timely for claiming a deduction for the taxable year ending September 30, 2019, the contribution is late for minimum funding purposes. The minimum funding deadline is September 15, 2019, which is 8½ months after the close of the plan year ending December 31, 2018.

Deadlines that Fall on Weekend or Holiday

If the due date of the employer's tax return falls on a holiday or weekend, then the due date is the next business day. For example, the due date for a sole proprietor's tax return for a taxable year ending December 31, normally would be April 15 of the following year. If that date is a Sunday, the due date will be April 16, rather than April 15. A qualified plan contribution made on April 16 meets the deduction deadline for the prior year ending December 31 and is deductible in that prior year.

The weekend/holiday rule also applies to extensions of the due date. For example, if a corporation obtained the 6-month extension on its tax return for a taxable year ending December 31, the extended due date normally would be September 15, of the following year. However, if that date is a Saturday,

[38] *Wenger v. Commissioner, T.C.* Memo 2000-156 (May 12, 2000).

the extended due date will be September 17. A qualified plan contribution made on September 17, would be within the permissible deduction period for the previous taxable year ending December 31.

Plan Must Be in Existence by End of Taxable Year for Which Deduction Is First Allowed

A deduction is not allowed for a prior taxable year if the plan is not established by the end of that taxable year.[39]

EXAMPLE 8-44. Establishment of Plan. Corporation Z is a calendar year corporation. It establishes a profit sharing plan on February 1, 2018. The plan cannot be made effective for the taxable year ending December 31, 2017, to obtain a deduction for 2017, because the plan is established after the close of the taxable year (i.e., after December 31, 2017).

Although the plan must be established by the end of the taxable year, it does not have to be funded by that date. Suppose, in the prior EXAMPLE 8-44, that Corporation Z actually adopted the plan by December 31, 2017, but did not make the initial contribution until March 15, 2019. Rev. Rul. 81-114 provides that state law is superseded to the extent it requires a minimum corpus (that is, some amount of money or value in the trust) to have a valid trust established by the end of the taxable year. Thus, the trust would be considered in existence by December 31, 2017, even though there was no corpus by that date, and the March 15, 2018, contribution would be deductible for the 2017 taxable year.

If employer contributions are discretionary (e.g., profit sharing plan), the employer may determine its deductible contribution for a prior year at any time up to the tax return due date, including extensions. The IRS does not require that minutes be adopted by the end of the taxable year to establish the amount of the deductible contribution under a profit sharing plan or stock bonus plan.[40] Make sure, however, that the plan document or corporate bylaws do not require a contribution to be established earlier.

Mailing of Contributions

In at least one private letter ruling, the IRS formally recognizes the date of mailing of a contribution check as the contribution date for deduction purposes.[41] In that ruling, a sole proprietor maintained a plan with a bank trustee. On the due date for filing his federal income tax return for a taxable year, he mailed the bank a contribution check for that year. The IRS ruled that the contribution was deductible for the taxable year, even though the bank did not actually receive that check until after the due date for the prior year's return, because the contribution date was deemed to be the postmark date. This is consistent with the IRS's view on filing tax returns by mail.

APPLICATION OF CERTAIN LIMITS TO DEDUCTION CALCULATIONS

In calculating the maximum deduction, the compensation dollar limit under IRC §401(a)(17) ($275,000 for 2018) applies. In addition, current deductions are not available for funding defined benefits in excess of the annual benefit limit under IRC §415(b) or for contributions to defined contribution plans that are excess annual additions under IRC §415(c).

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[39] Rev. Rul. 81-114, 1981-1 C.B. 207. Also see the last sentence of Treas. Reg. §1.401(b)-1(a). Whether a plan existed by the end of the taxable year was the issue in Engineered Timber Sales, Inc. v. U.S., 74 TC 808 (1980), where the court noted that a "plan" may consist of a "collection of writings which create a specific permanent plan."

[40] Field Service Advice (FSA) 199922005, PLR 8010123, and PLR 8042133. Rev. Rul. 71-38, 1971-1 C.B.130 (an employer had to establish a "fact of liability" prior to the close of its taxable year) was obsoleted by Revenue Ruling 84-50, 1984-1 C.B. 279.

[41] PLR 8536085.

Effect of Compensation Limit

The compensation dollar limit under IRC §401(a)(17) applies to any deduction limit under IRC §404 that is based on compensation.[42] Thus, the defined contribution deduction limit and the overlapping plan deduction limit are calculated by limiting a participant's compensation to the dollar limit in effect at the beginning of the taxable year for which the deduction limit is being computed.

EXAMPLE 8-45. Effect of IRC §401(a)(17) Compensation Limit on Deduction. Corporation Y's profit sharing plan has three participants—Dennis, Janet and Madison. Corporation Y's taxable year ends December 31. For the 2018 taxable year, Dennis' compensation is $295,000, Janet's compensation is $40,000, and Madison's compensation is $20,000. To compute the 25 percent deduction limit for defined contribution plans, only $275,000 of Dennis' compensation is taken into account, which is the compensation dollar limit in effect for a taxable year beginning in 2018. When only $275,000 of Dennis' compensation is added to the compensation for Janet and Madison, the aggregate compensation basis for purposes of computing the IRC §404(a)(3) deduction limit is $335,000. The IRC §404(a)(3) deduction limit is 25% x $335,000, or $83,750.

Effect of Elective Contributions

If a participant is deferring compensation under a 401(k) arrangement, or is making salary reduction contributions to a cafeteria plan, the compensation limit is applied to the gross compensation. This is because IRC §401(a)(12) includes elective contributions and cafeteria plan contributions in the definition of compensation that is used to compute the deduction limits under IRC §404(a)(3), (7), (8) and (9).

Suppose Corporation Y's plan (from **EXAMPLE 8-45**) includes a 401(k) arrangement, and Dennis' elective contributions for the 2018 taxable year total $17,000. Although his net compensation is only $278,000, the plan still uses $275,000 of his compensation to compute the deduction limit. This is because elective contributions are included in the compensation basis for deduction limit purposes. The $275,000 compensation limit is applied to Dennis' gross compensation of $295,000, not to his net compensation of $278,000. So, the deduction limit for the 2018 taxable year is the same as computed in EXAMPLE 8-45. Also note that the elective contributions would be deducted in full, and would not be taken into account to determine if Corporation Y's other contributions to the plan for the 2018 taxable year exceed the 25 percent limit.

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Effect of IRC §415 Limit

The IRC §415 limits must be taken into account in computing the maximum deduction limit.[43]

To compute the amount of the deduction allowable, the contributions taken into account are reduced by any annual additions in excess of the IRC §415 limits.[44] A money purchase plan or target benefit plan is subject to the defined contribution deduction limit, just like a profit sharing plan or stock bonus plan. Thus, it is possible that the minimum funding requirement for a money purchase plan or target benefit plan, although not exceeding the IRC §415 limit, could exceed the 25 percent of aggregate compensation limit and not be entirely deductible for the current year.

Language in Plan Will Usuually Limit contributions to teh Applicable IRC §415 Limit

A money purchase plan or target benefit plan typically will include language that reduces the

[42] IRC §404(l).
[43] IRC §404(j).
[44] IRC §404(j)(1)(B); IRS Notice 83-10, F-1 and F-2, 1983-1 C.B. 536.

required employer contribution to the extent the contribution would exceed the IRC §415 limit for any participant. Without such language, the minimum funding requirement under IRC §412 would require the employer to contribute excess annual additions that would be nondeductible and nonallocable to the participant's account. If an amount is contributed in excess of the IRC §415 limit, it is nondeductible, even if it is required by the minimum funding requirement and even if the total contribution does not exceed the 25 percent defined contribution deduction limit.

EXAMPLE 8-46. Target Benefit Plan Contribution. A target benefit plan provides for a contribution on behalf of each participant that is necessary to fund the participant's target benefit. Under the contribution method provided in the plan, the employer's contribution for a participant whose earnings are $100,000 and who is age 60 would be $56,000 for the plan year and limitation year beginning in 2018. If the plan did not have language to reduce the contribution for the IRC §415 limit, the employer would have a minimum funding requirement for 2018 of $56,000 for this participant. However, the IRC §415 limit in effect for 2018 would be $55,000, causing $1,000 of the total contribution to be nonallocable to the participant and nondeductible. This is true even if the aggregate contribution made on behalf of all participants does not exceed the 25 percent limit under IRC §404(a)(3), which is the applicable deduction limit for the target benefit plan.

Regulatory Correction of Excess Annual Additions

For excess annual additions that occurred before July 1, 2009, Treas. Reg. §1.415-6(b)(6) provided methods for correcting excess annual additions which arose from certain justifiable circumstances listed in the regulation. The regulation provided that excess amounts corrected in accordance with one of the regulatory correction methods "shall not be deemed annual additions in that limitation year." Because the excess amounts are treated as annual additions for later years, the excess was treated as not having occurred. Thus, IRC §404(j) would not result in the disallowance of the deduction for such amounts (assuming the limitations under IRC §404 are otherwise not exceeded), because IRC §404(j) only reduces the deduction for annual additions that exceed the IRC §415 limit. In April of 2009, the Treasury finalized regulations that eliminated these correction methods.[45] Excess annual additions must now be corrected using the Employee Plans Compliance Resolution System (EP-CRS).[46]

PURCHASES OF LIFE INSURANCE CONTRACTS

A qualified plan may provide for the purchase of life insurance contracts to fund death benefits under the plan. This is true for both defined contribution plans and defined benefit plans.

Generally, contributions made by the employer that are used to pay for insurance premiums on contracts held for the benefit of a participant are deductible in accordance with normal deduction rules applicable to defined contribution plans. In many cases, the premiums are paid from amounts already allocated to the participant's account (for example, previously allocated contributions or investment earnings allocated to the participant's account), so the payment does not directly affect the employer's deduction. All or a portion of the life insurance premium (called the taxable term cost or the PS-58 cost) is the cost of providing that year's life insurance protection. (Premiums in excess of the PS-58 costs pay expenses on the policy or are accumulated as cash values.) The cost of that year's insurance protection is considered to be a current, not deferred, benefit. As a result, the participant is subject to

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[45] T.D. 9319 (4/5/07).

[46] Rev. Proc. 2013-12.

current taxation on the PS-58 costs.[47]

Self-Employed Individuals

Contributions made on behalf of a self-employed individual for the purchase of life, accident, health, or other insurance are not deductible.[48] For example, PS-58 costs for the purchase of life insurance are not deductible. Because deductions available to the employer under IRC §404 are allocated to the self-employed individual, the disallowance of the deduction for PS-58 costs places the individual on par with the common-law employee, who must include in income the PS-58 costs deducted by the employer. By denying the self-employed individual the deduction, he or she is effectively including the PS-58 costs in income like the common-law employee.

DEDUCTION LIMITS FOR SELF-EMPLOYED INDIVIDUALS

IRC §404(a)(8) contains special rules for applying the deduction limits to plans that cover at least one self-employed individual [as defined by IRC §401(c)(1)]. An employee under IRC §404(a) includes a self-employed individual who is treated as an employee for qualified plan purposes,[49] and the employer of such individual is the person treated as the employer[50] (i.e., the partnership, if the self-employed individual is a partner, or the sole proprietorship, if the self-employed individual is the sole proprietor).[51] In addition, any of the deduction limits based on compensation are determined with respect to the self-employed individual's earned income, as defined in IRC §401(c)(2).[52]

Adjustment of Earned Income for Qualified Plan Deduction

IRC §401(c)(2) requires that, in determining the earned income of the self-employed individual, the individual's self-employment income derived from the employer maintaining the plan is reduced by the deductions allowed under IRC §404.[53] If the self-employed individual is a sole proprietor, this reduction will be for the entire qualified plan deduction taken under IRC §404, including the deduction taken for contributions made on behalf of the individual's employees, because the sole proprietor is also the employer under IRC §401(c)(4). However, if the self-employed individual is a partner in a partnership, this reduction is only for the partner's share of the qualified plan deduction allowed to the partnership under IRC §404 for the contributions made on behalf of the partnership's employees, plus the deduction taken for the contributions on behalf of that partner.[54] The effect the reduction of earned income has on computing the applicable deduction depends on the type of plan.

Effect of Elective Contributions

IRC §404(a)(12) provides that the term "compensation" includes elective contributions under a 401(k) arrangement. IRC §404(a)(12) references several paragraphs of IRC §404(a) to which this rule applies, including paragraph (8), which pertains to the deduction limits applicable to self-employed individuals. Therefore, the adjustment for the IRC §404 deduction, as described in the prior paragraph, does not include the 401(k) elective contributions made by the self-employed individual.

Although the deductibility of the employer's contribution is governed by IRC §404, IRC §404(a)

[47] IRC §72(m)(3).
[48] IRC §404(e).
[49] IRC §401(c)(1).
[50] IRC §401(c)(4).
[51] IRC §404(a)(8)(A).
[52] IRC §404(a)(8)(B) and (D).
[53] IRC §401(c)(2)(A)(v).
[54] Treas. Reg. §1.404(e)-1A(f)(1).

requires that the contributions otherwise be deductible under the IRC. This means that the contributions, which represent deferred compensation, would have to satisfy the reasonable compensation requirements of IRC §§162 and 212. Accordingly, IRC §404(a)(8)(c) provides that the contributions to a qualified plan that are made on behalf of a self-employed individual satisfy the conditions of IRC §162 or IRC §212 only to the extent that the contributions do not exceed the individual's earned income (determined without regard to the qualified plan deduction). In other words, the pre-deduction earned income can be zeroed-out with respect to the contribution made on the individual's behalf, but additional contributions would fail to be deductible because they would not be treated as satisfying the requirements of IRC §162. This is primarily an issue with respect to a defined benefit plan maintained by the individual, because the 100 percent annual additions limit under IRC §415(c)(1)(B) for defined contribution plans would preclude contributions from exceeding 100 percent of the pre-deduction earned income anyway.

DEDUCTIONS FOR SHORT TAXABLE YEAR OR SHORT PLAN YEAR

A short taxable year may affect the computation of the employer's deduction. A short taxable year occurs when the employer changes its taxable year. If the plan year matches the employer's taxable year, an employer usually will amend the plan year when the taxable year is changed. A change in plan year may also affect the deduction limits.

Defined Contribution Plans

In the case of a short taxable year, the IRC §404(a)(3) deduction limit is applied to aggregate participant compensation paid for the short period.

EXAMPLE 8-47. Taxable Year and Plan Year Both Amended. Corporation X maintains a profit sharing plan. Effective January 1, 2018, Corporation X's taxable year is changed from a June 30 year to a calendar year, creating a short period from July 1 to December 31, 2017. The plan year is also amended to the calendar year, creating a short plan year that matches the short taxable year. The participants' aggregate compensation for the short taxable year is $300,000. The maximum deductible contribution for the short taxable year is $75,000 (i.e., 25% x $300,000).

EXAMPLE 8-48. Taxable Year Changed But Plan Year Not Amended. Suppose the plan year is not amended in the prior **EXAMPLE 8-47**. On March 1, 2018, Corporation X makes a $75,000 contribution for the short taxable year. The contribution is allocated for the plan year ending June 30, 2018 (i.e., the plan year in which the contribution is made). Because the contribution is being deducted for the short taxable year ending December 31, 2017, it has to be allocated, in accordance with Rev. Rul. 76-28, in the same manner as a contribution made on December 31, 2017, would be allocated. Allocation of a December 31, 2017, contribution for the plan year ending June 30, 2018, would satisfy this requirement. If the plan defines the compensation period for allocation purposes as the plan year, the contribution is allocated on the basis of participant compensation for the plan year July 1, 2017, through June 30, 2018. The fact that the deduction for the contribution is based on compensation for the six-month taxable year does not affect the allocation of the contribution for the 12-month plan year.

EXAMPLE 8-49. Contributions Deductible in Two Different Taxable Years Allocated for Same Plan Year. In the prior **EXAMPLE 8-48**, Corporation X wants to contribute more than $75,000 for the plan year ending June 30, 2018. On November 1, 2018, it contributes an additional $80,000 and designates the contribution for the plan year ending June 30, 2018. As long as

the IRC §415 limits are not exceeded, the $80,000 contribution made on November 1, 2018, may be allocated for the plan year ending June 30, 2018, along with the $75,000 contribution made on March 1, 2018. (We are assuming the limitation year for IRC §415 purposes is the same as the plan year.) However, the $75,000 contribution will be deducted for the short taxable year ending December 31, 2017, based on aggregate participant compensation for that taxable year, while the $80,000 contribution will be deducted for the taxable year ending December 31, 2018, based on that year's aggregate participant compensation.

A short plan year does not directly affect the deduction limit under IRC §404(a)(3) because the deduction limit is based on participant compensation for the employer's taxable year. In **EXAMPLE 8-47**, the plan year was changed along with a change in taxable year, so the contribution deducted for the short tax period was also allocated with respect to a corresponding short plan year period. In some cases, the plan year is changed without a corresponding change in the taxable year. When that happens, the computation of the deduction limit is not affected because the taxable year is unchanged. However, the employer will need to designate for which plan year the contribution is made.

EXAMPLE 8-50. Change in Plan Year. Corporation W maintains a profit sharing plan. Corporation W's taxable year ends September 30. The profit sharing plan was originally established with a September 30 plan year and limitation year, but effective January 1, 2018, the plan year is amended to the calendar year. There is a short plan year from October 1 to December 31, 2017.

For Corporation W's taxable year ending September 30, 2018, the aggregate participant compensation is $800,000. The maximum deduction for that taxable year is 25% x $800,000, or $200,000. Corporation W contributes $200,000 on October 20, 2018, and deducts the contribution for the taxable year ending September 30, 2018. Corporation W designates $35,000 of that contribution for the short plan year ending December 31, 2017, and the rest for the 2018 plan year. This is an acceptable treatment of the contribution. The fact the deduction is taken for the taxable year ending September 30, 2018, does not affect the manner in which the contribution is allocated.

If the compensation period for allocation purposes is the plan year, the $35,000 contribution designated for the short year will be allocated on the basis of a three-month compensation period (October 1 through December 31, 2017). The remainder of the contribution will be allocated for the 2018 year based on compensation for that calendar year.

Additional contributions could be made for the 2018 plan year and deducted for Corporation W's taxable year ending September 30, 2018. To preserve deductibility, however, the contributions made for a particular limitation year (usually defined as the plan year) must be within the IRC §415 limits.

EXCISE TAX ON NONDEDUCTIBLE CONTRIBUTIONS

If the employer's contribution for a taxable year exceeds the applicable deduction limit, a 10 percent excise tax applies on the nondeductible amount.[55] The excise tax is not deductible by the employer.[56] The following types of plans are subject to the excise tax provisions:

- qualified plans [as described in IRC §401(a) or IRC §403(a)];
- SEPs; and
- SIMPLE IRA plans.

[55] IRC §4972.

[56] IRS Notice 87-37, 1987-1 C.B. 499.

EXAMPLE 8-51. Nondeductible Contributions to a Profit Sharing Plan. Corporation S maintains a profit sharing plan. The plan year and the corporation's taxable year are the calendar year. The aggregate participant compensation for the corporation's 2018 taxable year is $1,000,000. The profit sharing plan deduction limit for that taxable year is $250,000. On November 1, 2018, Corporation S contributes $280,000 to the profit sharing plan. The nondeductible portion of the contribution is $30,000, and the excise tax is 10 percent of that amount, or $3,000. Note that, although the $280,000 is not fully deductible for the 2018 taxable year, it generally will be allocated for the plan year ending December 31, 2018, because it was contributed during that plan year and is not attributable to a prior plan year.

EXAMPLE 8-52. Profit Sharing Contribution Made After Close of Year. Suppose in the prior **EXAMPLE 8-51** that Corporation S made the contribution on February 1, 2019 instead of on November 1, 2018. Because the contribution is made after the end of the taxable year, Corporation S is not forced into an excise tax situation. Corporation S may designate $250,000 of the contribution for the 2018 taxable year, and designate the remaining $30,000 as part of its 2019 contribution for deduction purposes.

This second example illustrates the advantage of making contributions after the close of the taxable year. If an employer wishes to contribute during the taxable year, it is advisable to do so conservatively (e.g., contribute 60 percent of what the employer thinks the maximum deduction will be).

Arguably, the excise tax should not apply in **EXAMPLE 8-52**, even if the employer treats the entire $280,000 as a contribution for the plan year ending December 31, 2018 (assuming it can all be allocated without violating the IRC §415 limits), because the contribution was not actually made by December 31, 2018. The Code section that outlines the excise tax (IRC §4972(a)) determines the amount of the nondeductible contributions as of the close of the taxable year, and does not specifically incorporate the deduction rule that treats contributions made by the due date of the tax return as having been contributed as of the last day of the prior taxable year.

Because it is not clear whether contributions made after the plan year but before the tax return due date (including extensions) and allocated for the prior year are to be taken into account for excise tax purposes, making the nondeductible contribution after the deduction deadline may provide added assurance that the excise tax is not applicable. Contributions made up to 30 days after the deduction deadline may be treated as annual additions for the limitation year that ends in the employer's tax year.[57] In **EXAMPLE 8-52**, if the employer's return for the 2018 tax year is due on April 15, 2019, a contribution made between April 16 and May 14, 2019, could still be allocated as an annual addition for the 2018 limitation year, because it is made within 30 days after the contribution deadline for tax deduction purposes. This should alleviate concerns about the excise tax because the contribution could not be treated as made as of the close of the year for deduction purposes, which is the basis of the IRC §4972 excise tax.

Nondeductible Contributions to a Money Purchase Plan

Suppose a money purchase plan calls for an annual employer contribution of 6 percent of compensation. The employer funds the contribution during the year by making monthly deposits to the plan. By the end of the plan year, the employer has contributed $71,000 for that year's funding requirement. However, the employer made its monthly deposits by anticipating estimated participant compensation. It is later determined that the actual funding requirement for the plan year is only $65,000, so the employer has overfunded the money purchase plan by $6,000. This excess is not deductible and is subject to the excise tax under IRS §4972.

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Nondeductible Contributions to a Target Benefit Plan

The minimum funding requirement for a target benefit plan is based on the contribution required

[57] Treas. Reg. §1.415-6(b)(7)(ii).

to fund the target benefit, using the theoretical reserve method outlined by the nondiscrimination testing regulations.[58] Suppose that, because of the advanced age of certain participants, an employer's contribution to its target benefit plan for the taxable year beginning January 1, 2018, is $190,000. The aggregate participant compensation is $700,000, so the defined contribution deduction limit is 25% x $700,000, or $175,000. If more than $175,000 of the 2018 target benefit contribution has been funded by December 31, 2018, the 10 percent excise tax under IRC §4972 applies.

It is important that the plan document address the potential conflict between the target benefit formula and the deduction limitations. It is possible that one or more participants may be entitled to a target benefit allocation that exceeds 25 percent of compensation, which might cause the employer's total required contribution to exceed the 25 percent defined contribution plan deduction limit. The employer may want to cap the maximum annual contribution that may be made on a participant's behalf, to minimize the chances of exceeding the deduction limit. Note, however, that because the deduction limit is an aggregate limit, based on the combined compensation of all participants, the deduction limit will not necessarily be exceeded merely because one, or even several, employees receive an allocation in excess of 25 percent of compensation.

Returning Contributions to Eliminate Excise Tax

If an employer contribution is returned before the tax return due date (including extensions) for the taxable year, that amount is not taken into account in determining whether an excise tax applies.[59] However, the exclusive benefit rule precludes an employer contribution from being returned merely because it exceeds the deduction limit. The contribution may be returned only under limited circumstances—mistake of fact, disallowance of deduction or failure for the plan to qualify from its inception.[60]

The IRS ruled that the mere nondeductibility of a contribution is not a mistake of fact.[61] In addition, a reversion for disallowance of deduction requires the IRS to formally disallow the deduction. There is no ruling procedure under which a defined contribution plan sponsor may request that the IRS deem the contribution to be nondeductible, although one does exist for defined benefit plans.[62]

Carryforwards Subject to Additional Excise Taxes Until Absorbed Under Deduction Limits

In cases in which the nondeductible contribution cannot be returned to the employer, the nondeductible amount is carried forward under the applicable deduction rules, as discussed earlier. A 10 percent excise tax will apply for any succeeding taxable year in which the nondeductible amount is not absorbed under the applicable deduction limits for that year.

EXAMPLE 8-53. Carryforward of Nondeductible Amount to Following Tax Year. The deduction limit under a profit sharing plan for the employer's 2017 calendar taxable year is $80,000. The employer contributes $100,000 on November 1, 2017. The 10 percent excise tax applies to the nondeductible amount of $20,000, for an excise tax of $2,000.

For the 2018 taxable year, the deduction limit is $145,000. On December 1, 2018, the employer contributes $140,000 for 2018. The $20,000 nondeductible contribution is carried over to 2018 for deduction purposes. When the $20,000 carryforward is added to the current year contribution of $140,000 for 2018, the contributions total $160,000 and the $145,000 limit is exceeded by $15,000. A 10 percent excise tax applies to the nondeductible amount of $15,000, for an excise tax of $1,500 with respect to the

[58] Treas. Reg. §1.401(a)(4)-8(b)(3).
[59] IRC §4972(c)(3).
[60] Rev. Rul. 91-4, 1991-1 C.B. 57.
[61] IRS Notice 89-52, Q&A-16, 1989-1 C.B. 692.
[62] Rev. Rul. 90-49, 1990-2 C.B. 620.

December 1, 2018, contribution. (The nondeductible amount from 2017 is treated as deductible first in determining what portion of the 2018 contribution is nondeductible for IRC §4972 purposes.[63])

Form 5330 Must Be Filed to Pay Excise Tax

The employer pays the excise tax due to nondeductible contributors by filing Form 5330. The due date for the excise tax is the last day of the 7th month following the taxable year for which there was a nondeductible contribution as of the close of the year. For example, if the taxable year ends December 31, 2018, the due date for the Form 5330 for nondeductible contributions determined as of the close of that year is due July 31, 2019.

Form 5558 may be filed to extend this deadline by no more than six months. The extension does not apply to the payment of the tax, only to the filing deadline, so the tax due must be submitted with the extension request.

Form 5558 is the same form that is filed to obtain an extension for filing Form 5500. The extension is automatically granted for the Form 5500 if Form 5558 is filed timely. However, the extension for filing Form 5330 is not automatic, and is subject to approval by the IRS.

If You're Curious . . .

Exceptions to the Excise Tax

Exception for Tax-Exempt and Governmental Employers

A tax-exempt organization or a governmental employer is not subject to the excise tax on nondeductible contributions.[64] Because of this rule, a tax-exempt organization or governmental employer may exceed the 25 percent deduction limit for profit sharing plans without incurring an excise tax. There is no qualification requirement under IRC §401(a) that contributions to a profit sharing plan must be limited to the deduction limit. Because there is no excise tax under IRC §4972, there is no adverse consequence for a tax-exempt or governmental employer that contributes more than the deduction limit under IRC §404.

Employer contributions by a tax-exempt employer to a profit sharing plan could exceed 25 percent of compensation, as long as the IRC §415 limits are not exceeded. Also note that the IRC §415(c) limit is the lesser of 100 percent of compensation or the applicable dollar limit under IRC §415(c)(1)(A), providing a great deal of contribution room for a tax-exempt organization.

The IRS takes the position that, when a tax-exempt organization maintains a plan jointly with one or more of its for-profit subsidiaries, the excise tax under IRC §4972 applies to contributions made by the tax-exempt organization that would otherwise exceed the IRC §404 deduction limits. Under the ruling outlining this position, a tax-exempt organization and its wholly owned for-profit subsidiary jointly sponsored a defined benefit plan. Contributions that exceeded the deduction limits under IRC §404(a)(1) were made to the plan. Because a non-exempt subsidiary of the tax-exempt organization also maintained the defined benefit plan, the IRS ruled that the exception under IRC §4972(d)(1)(B) did not apply. The IRS ruled that the excise tax applied even to the nondeductible contributions made by the tax-exempt organization.[65]

Contributions to Defined Contribution Plans that are Nondeductible by Reason of IRC §404(a)(7)

If contributions to one or more defined contribution plans are nondeductible because of the overall

[63] Notice 87-37.
[64] IRC §4972(d)(1)(B).
[65] TAM 9616003.

deduction limit applicable to overlapping plans under IRC §404(a)(7), the excise tax does not apply to the extent such nondeductible contributions do not exceed the amount of matching contributions. This exception is effective for taxable years beginning on or after January 1, 2006.[66]

Prior to 2006, the exception from the excise tax applied to the extent the nondeductible contributions did not exceed the greater of:

1. 6 percent of aggregate participant compensation; or
2. The amount of matching contributions made for the taxable year.[67]

PPA amended this provision to eliminate the six percent rule because employer contributions up to six percent of the aggregate participant compensation are now deductible, making that portion of the excise tax exception unnecessary. Note that this rule does not cause matching contributions in excess of the 6 percent limit to be deductible; it simply ignores them in calculating how much of the nondeductible contribution is subject to the excise tax.

Remember that, pursuant to IRC §404(n), elective contributions are deducted separately, are not subject to the overlapping plan deduction limitation under IRC §404(a)(7) and are not taken into account in determining whether any other contributions cause the limit to be exceeded.

Disregarding Certain Defined Benefit Plan Contributions to Determine Nondeductible Contributions

The IRC allows the determination of the nondeductible amount, for purposes of IRC §4972, to be calculated by not taking into account any contributions to a defined benefit plan. If this exception is elected, the exception previously described relating to matching contributions cannot apply.[68] How could this exception be helpful? Consider the following example.

EXAMPLE 8-54. IRC §404(a)(7) Causes Part of Defined Contribution to be Nondeductible. An employer maintains both a defined benefit plan and a defined contribution plan. Suppose, for a given taxable year, the minimum funding requirement to the defined benefit plan sharply increases, which causes the portion of the defined contribution plan contribution in excess of 6 percent to be nondeductible solely because of the overlapping plan deduction limit under IRC §404(a)(7). The exception previously described will not eliminate the entire excise tax, because the nondeductible contribution exceeds the maximum amount eligible for the exception.

If the employer elects the exception under IRC §4972(c)(7) instead, the entire portion of the contribution to the defined contribution plan that exceeds the IRC §404(a)(7) limit would not be subject to the excise tax under IRC §4972 because the contributions to the defined benefit plan would be entirely disregarded to determine the amount of the contributions that are considered to be nondeductible for purposes of the excise tax.

This rule does not make the entire contribution to the defined contribution plan deductible; it simply provides relief from the excise tax with respect to the portion of the contribution that is not deductible.

[66] IRC §4972(c)(6)(A), as amended by section 803(c) of the PPA 2006.
[67] IRC §4972(c)(6)(A), as in effect prior to 2006.
[68] IRC §4972(c)(7), last sentence.

Section 8.04: Review of Key Concepts

- Describe the deduction limit for defined contribution plans.
- What compensation is taken into account for purposes of determining the maximum deductible contribution?
- Describe the computation period and any applicable limits relating to compensation used in determining deduction limits.
- Identify the deadlines for making deductible contributions for different types of business entities.
- What are overlapping plans?
- Describe the deduction limits for overlapping plans.
- What happens if an employer contributes an amount in excess of the deduction limit?

Section 8.05: For Practice – True or False

1. A qualified plan must be established by the end of the employer's tax year for the employer's contribution for that plan year to be deductible.
2. Compensation for deduction purposes is determined based on the employer's tax year.
3. Elective contributions are applied towards the employer's defined contribution plan deduction limit under IRC §404(a)(3).
4. The deduction limit for overlapping plans is 25 percent of eligible compensation.
5. Employer contributions in excess of the deduction limit may be carried forward and deducted in subsequent years.
6. Compensation used for deduction purposes is net of elective contributions.
7. Forfeitures allocated in a profit sharing plan do not reduce an employer's deduction limit.
8. Compensation for deduction purposes includes taxable fringe benefits.
9. The employer owes a 10 percent excise tax on any nondeductible contributions made to a defined contribution plan, unless an exception applies.
10. The deadline (with extension) for making a deductible contribution to a corporation's calendar year profit sharing plan is April 15th provided that the corporation's fiscal year is also the calendar year.

Section 8.06: Sample Test Questions

1. Based on the following information, determine the maximum deductible employer nonelective contribution for 2018:
    - The plan is a calendar year 401(k) profit sharing plan.
    - The effective date of the plan is January 1, 2018.
    - The plan has a non-integrated allocation formula for the employer nonelective contribution.
    - This is the only plan the employer sponsors.
    - The compensation limit for 2018 is $275,000.
    - The participants' elective contributions for the year total $27,000.
    - Employer matching contributions for the year total $13,500.
    - The participants listed are all eligible to receive an allocation of employer nonelective contributions.

Eligible Participant	2018 Compensation
A	$210,000
B	$45,000
C	$30,000

A. $30,750
B. $40,500
C. $44,250
D. $57,750
E. $71,250

2. All of the following statements regarding deduction rules are TRUE, EXCEPT:
   A. Contributions made in excess of the deduction limit will result in plan disqualification.
   B. When the plan year and the employer's tax year are different, the maximum deduction limit is based on compensation paid in the employer's tax year.
   C. An employer may make a deductible contribution to a profit sharing plan in the form of property instead of cash.
   D. Compensation used for deduction purposes includes salary reduction contributions to a cafeteria plan.
   E. Employers that maintain a profit sharing plan and a money purchase plan do not have a higher deduction limit than those employers who maintain only one of these types of plans.

3. All of the following statements regarding deduction rules are TRUE, EXCEPT:
   A. The maximum deductible contribution for a combination of money purchase and profit sharing plans is 25% of eligible plan compensation.
   B. A contribution that exceeds the IRC §415 limit is not deductible.
   C. An employer that contributes 20 percent of eligible compensation in year one, may carry over the unused 5 percent and increase its deduction limit to 30 percent in year two.
   D. The excise tax on nondeductible contributions made by December 31, 2018, must be paid by July 31, 2019.
   E. All defined contribution plans maintained by a single employer are treated as a single plan in determining deduction limits.

4. Based on the following information, determine the amount of the nondeductible contribution for 2018:
   - The plan is a calendar year profit sharing plan.
   - The plan sponsor is a calendar year tax filer.
   - The aggregate compensation for deduction purposes is $800,000.
   - On October 1, 2018, the plan sponsor deposits $275,000 for the 2018 contribution.

   A. $0
   B. $75,000
   C. $120,000
   D. $155,000
   E. $200,000

5. Which of the following statements regarding overlapping plans is/are TRUE?
   I. An overlapping plan occurs when an employer maintains at least one defined contribution plan and at least one defined benefit plan, and at least one employee participates in both plans.

II. The overlapping plan deduction limit is never less than the minimum funding requirement applicable to the defined benefit plan.
III. For post-PPA years, the 25 percent limit does not apply if a defined contribution plan contribution does not exceed 6 percent of compensation.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

6. All of the following statements regarding tax return and corresponding contribution deadlines are TRUE, EXCEPT:
   A. The filing deadline for a calendar year partnership is April 15 if an extension has not been filed.
   B. The filing deadline for a calendar year sole proprietorship is April 15 if an extension has not been filed.
   C. The filing deadline for a calendar year sole proprietorship is October 15 if an extension has been filed.
   D. The filing deadline for a calendar year LLC taxed as a corporation is April 15 if an extension has not been filed.
   E. The filing deadline for calendar year LLC taxed as a corporation is October 15 if an extension has been filed.

7. Which of the following statements regarding nondeductible contributions is/are TRUE?
   I. The plan is liable for any applicable excise tax on nondeductible contributions.
   II. Nondeductible contributions may be carried forward and deducted in succeeding taxable years.
   III. The excise tax is applicable in subsequent years if the nondeductible contribution has not been deducted in the subsequent year.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

8. Based on the following information, determine the maximum deductible employer nonelective contribution that may be made to the following 401(k) plan:

Total compensation of all eligible participants	$1,000,000
Total of participants' elective contributions	$50,000
Total employer matching contribution	$25,000

   A. $0
   B. $175,000
   C. $200,000
   D. $225,000
   E. $250,000

9. Which of the following statements regarding nondeductible contributions is/are TRUE?

    I. Nondeductible contributions must be withdrawn from the plan no later than 90 days from the date made to avoid an excise tax.
    II. The excise tax is due by the last day of the seventh month following the taxable year of the nondeductible contribution.
    III. Obtaining an extension for filing Form 5500 automatically extends the date for payment of the excise tax on nondeductible contributions.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

10. All of the following statements regarding overlapping plan deduction rules under IRC §404(a) (7) are TRUE, EXCEPT:

    A. Overlapping plan deduction limits generally apply when an employer sponsors a defined contribution plan and a defined benefit plan.
    B. Elective contributions are not taken into account when determining if the overlapping plan deduction limits have been satisfied.
    C. Matching contributions are considered when determining if the overlapping plan deduction limits have been satisfied.
    D. The overall deduction will not exceed the overlapping plan limit if it is less than the minimum funding requirement for the defined benefit plan.
    E. The overlapping plan deduction limit will never exceed 25 percent of compensation.

See next page for answers to the true/false and sample test questions.

Section 8.07: Solutions to True or False Questions

1. True.
2. True.
3. False. Elective contributions are deducted separately by the employer. They are not included with other employer contributions when determining if the deduction limit has been exceeded.
4. False. The deduction limit for overlapping plans may exceed 25 percent of compensation, depending on the minimum funding requirement for the defined benefit plan. The maximum deduction under IRC §404(a)(7) is the greater of 25 percent of compensation or the amount needed to meet minimum funding standards for the defined benefit plan plus a contribution of 6 percent of compensation to the defined contribution plan.
5. True.
6. False. Elective contributions are included in compensation for deduction purposes.
7. True.
8. True.
9. True.
10. False. The deadline is October 15th.

Section 8.08: Solutions to Sample Test Questions

1. The answer is **D**. The maximum deductible contribution is 25 percent of eligible compensation, or ($210,000 + $45,000 + $30,000) x .25 = $71,250. $13,500 of this has already been used by the employer matching contributions so the maximum deductible employer nonelective contribution is $57,750 ($71,250 total permissible deduction - $13,500 employer matching contribution). The elective contributions are deducted separately and are not included with other employer contributions when determining if the deduction limit has been exceeded.
2. The answer is **A**. Contributions in excess of the deduction limit are subject to an excise tax, but will not necessarily result in plan disqualification.
3. The answer is **C**. The deduction limit is a one-year proposition. Unused amounts in one year may not be carried to future years.
4. The answer is **B**. The deductible contribution is 25 percent of eligible compensation or $800,000 x .25 = $200,000. The plan sponsor deposited $275,000, so the amount deposited that is not deductible is $75,000.
5. The answer is **E**. All three statements regarding overlapping plans are true.
6. The answer is **A**. The filing deadline for a calendar year partnership is March 15 if an extension has not been filed.
7. The answer is **D**. The employer is liable for any applicable excise tax on nondeductible contributions.
8. The answer is **D**. The deductible contribution is 25 percent of eligible compensation or $1,000,000 x .25 = $250,000. $25,000 of this has been used by the matching contributions, so $225,000 is available for employer nonelective contributions. Elective contributions deferred by plan participants to the 401(k) are deducted separately by the employer and are not included with other employer contributions when determining if the deduction limit has been exceeded.
9. The answer is **B**. Nondeductible contributions may not be withdrawn from the plan solely because they exceed the deduction limit. Obtaining an extension for filing Form 5500 does not extend the date for payment of the excise tax on nondeductible contributions. Excise taxes due on nondeductible contributions are paid by filing Form 5330, not by filing Form 5500. Form 5558 may be filed to extend the deadline for Form 5330, but the extension is not automatic. Rather, it is subject to approval by the IRS.

10. The answer is **E**. The overlapping plan deduction limit may exceed 25 percent of compensation under certain circumstances. The deductible limit for both of the overlapping plans combined is limited to the greater of:
    - 25 percent of compensation, plus up to 6 percent of compensation to the defined contribution plan (in other words 31 percent, if 6 percent is contributed to the defined contribution plan); or
    - The amount necessary to meet defined benefit plan's minimum funding requirement for year, plus a contribution of 6 percent of compensation to the defined contribution plan.

CHAPTER 9:
REQUIREMENTS FOR VESTING

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Section 9.01: Key Terms

- 12-consecutive-month period
- Break in service
- Contributory plan
- Counting-hours method
- Elapsed time method
- Five-year break-in-service rule
- Five-year cliff
- Forfeitable portion
- Forfeiture
- Immediate vesting
- One-year break-in-service rule
- Period of service
- Period of severance
- Rule of parity
- Service-spanning rule
- Seven-year graded
- Six-year graded
- Statutory minimum schedule
- Three-year cliff
- Vested benefit
- Vested interest
- Vesting
- Vesting computation period
- Vesting schedule

Section 9.02: Introduction

The actual benefit a participant receives from a qualified retirement plan is based on several factors, including the participant's years of service, his or her account balance or the value of benefit accrual, and the vesting schedule used by the plan. A qualified retirement plan must provide that the vesting of a participant's benefit satisfies the minimum required vesting standards.

This chapter will discuss the various requirements related to vesting and how vesting is applied to a participant's account upon certain events, including termination of employment. This will include a discussion of what constitutes a year of service for vesting, how breaks in service affect the years of service a participant earns for vesting, the timing and allocation of forfeitures and the effect of a change to the vesting schedule.

In the early part of the 2000s, Congress changed the minimum vesting schedules to be more beneficial for participants in defined contribution plans. In 2002, as part of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), more generous schedules that previously applied only to top-heavy plans were required for matching contributions. In the Pension Protection Act of 2006 (PPA), Congress extended those more generous schedules to all accounts in a defined contribution plan. Therefore, the older statutory schedules (i.e., the five-year cliff and seven-year graded schedules) are available now only to defined benefit plans.

Section 9.03: Vesting: Schedules and Timing

WHAT IS VESTING?

Vesting refers to the ownership that a participant has in his or her account balance or accrued benefit. The **vested interest** is the portion of a participant's benefit that cannot be taken away. As a result, when the participant terminates employment or otherwise becomes eligible for a distribution from the plan, the vested portion is the amount that is payable to him or her. Immediate, or 100 percent, vesting means that the participant has full ownership in any such contributions (including earnings on such contributions) without regard to length of service.

The portion of a participant's account balance or accrued benefit that is not vested is the **forfeitable portion** of the benefit. When a participant loses his or her interest in the forfeitable portion of the benefit, that portion (then called a forfeiture) may be used to pay plan expenses, to offset employer contributions, or as an allocation to other participants to increase the benefits they receive under the plan.

VESTING SCHEDULES

Each plan must designate a **vesting schedule**, which is a schedule that outlines how participants will vest in their account balance or accrued benefits. A vesting schedule defines the percent of the total account balance or accrued benefit that belongs to the participant at any given point in time, and is based upon a participant's years of service. The vested percentage is multiplied by the participant's account balance or accrued benefit to determine the amount of the participant's vested interest. The law provides minimum standards for a plan's vesting schedule.[1]

Statutory Minimum Vesting Schedules for Employer Contributions in a Defined Contribution Plan

A defined contribution plan may satisfy the legal vesting requirements for employer contributions under one of two **statutory minimum schedules**:

- three-year cliff vesting; or
- six-year graded vesting.

Prior to PPA, these schedules were required for matching contributions and top-heavy plans only.

Three-Year Cliff Vesting

Under **three-year cliff** vesting, the employee becomes 100 percent vested once he or she is credited with three years of service.[2] Prior to his or her completion of the third year of service, the employee's vesting percentage is zero. This schedule is known as cliff vesting because the employee will jump from no vesting to 100 percent vesting once he or she completes the third year of service.

Six-Year Graded Vesting

Under **six-year graded** vesting, an employee becomes 100 percent vested once he or she is credited with at least six years of service.[3] Because 100 percent vesting can be delayed longer under this option, the law requires that a minimum vesting percentage apply to earlier years. The minimum percentages prior to full vesting are as follows:

Upon completion of 1 year of service	0% vesting
Upon completion of 2 years of service	20% vesting
Upon completion of 3 years of service	40% vesting
Upon completion of 4 years of service	60% vesting
Upon completion of 5 years of service	80% vesting
Upon completion of 6 years of service	100% vesting

Immediate Vesting Alternative

Some plans avoid the issue of vesting schedules by simply providing that all participants are 100 percent vested in all accrued benefits at all times. These plans are known as immediate vesting plans. An immediate vesting approach would always satisfy the minimum vesting schedules. If a plan requires more than one year of service for eligibility purposes, the immediate vesting approach is required on all contribution sources.

When a plan uses immediate vesting, the need to keep track of service for vesting purposes is eliminated (although the employer may still need to keep track of service for eligibility purposes), the vesting break-in-service rules, as described

[1] IRC §§411(a)(2) and 416(b); ERISA §203(a)(2).
[2] IRC §411(a)(2)(B(ii)); ERISA §203(a)(2)(B)(ii).
[3] IRC §411(a)(2)(B)(iii); ERISA §203(a)(2)(B)(iii).

below, are irrelevant and there are no forfeitures to track and apply. For the majority of plans, where the eligibility service condition is one year of service or less, the use of the immediate vesting approach is purely a plan design decision.

Permissible Variations

A plan may design a customized cliff or graded vesting schedule, provided that participants are no less vested at any point in time than they would be under the statutory cliff or graded vesting schedules.

If the plan's schedule provides for 100 percent vesting by the third year, then it does not matter what the percentages are in earlier years. If the plan's schedule does not reach 100 percent by the time required under the three-year cliff schedule, then the vesting percentage in any year may not be less than the minimum percentage required under the six-year graded vesting schedule.

EXAMPLE 9-1. Qualification of Nonstatutory Vesting Schedule. Suppose a defined contribution plan's vesting schedule for employer nonelective contributions is as follows:

Fewer than 3 years of service	0% vesting
Upon completion of 3 years of service	60% vesting
Upon completion of 4 years of service	80% vesting
Upon completion of 5 years of service	100% vesting

Even though this schedule provides 100 percent vesting earlier than is required under the six-year graded vesting schedule, it does not provide at least the minimum percentages required for earlier years. The six-year graded schedule requires at least 20 percent vesting after the second year of service and 40 percent vesting after the third year of service. The schedule also does not satisfy the three-year cliff vesting schedule because the 100 percent vesting does not occur until five years of service. Therefore, this schedule violates the statutory requirements and would cause the plan to be disqualified if not corrected.

EXAMPLE 9-2. Qualification of Nonstatutory Vesting Schedule. A plan provides for the following vesting schedule:

Fewer than 2 years of service	0% vesting
Upon completion of 2 years of service	10% vesting
Upon completion of 3 years of service	100% vesting

This schedule satisfies the statutory requirements because it is at least as liberal at all points as the three-year cliff schedule. Because 100 percent vesting occurs upon completion of three years of service, it does not matter what the earlier vesting percentages are, even though 10 percent upon completion of two years of service would not satisfy the six-year graded schedule.

FULL VESTING REQUIRED

Some situations and contributions sources require full vesting.

Normal Retirement Age (NRA)

Regardless of the vesting schedule provided by the plan, the plan must provide that an employee is 100 percent vested at NRA.[4]

[4] IRC §411(a)/ERISA §203(a).

EXAMPLE 9-3. Vesting on NRA. A profit sharing plan uses the six-year graded vesting schedule. As of the plan year ending December 31, 2017, Julie has four years of service and is 60 percent vested on the vesting schedule. NRA under the plan is 65. Julie's 65th birthday is March 1, 2018. On March 1, 2018, Julie's vesting increases to 100 percent.

Two-Year Eligibility Plans

A plan may require two years of service as an eligibility requirement (although some contribution sources such as elective contributions are limited to one year of service for eligibility purposes).[5] If a plan requires more than one year of service for eligibility purposes, the plan must provide for immediate vesting on any contributions sources to which the two-year eligibility requirement applies.

401(k) Elective Contributions and After-Tax Employee Contributions

Elective contributions made to a 401(k) plan, and employee contributions made on an after-tax basis to a plan, must always be 100 percent vested. In other words, any vesting schedule stated in the plan will not be applicable to the portion of a participant's account balance that is attributable to such contributions (including investment earnings on such contributions). This also includes designated Roth contributions.

QMACs and QNECs

Qualified matching contributions (QMACs) and qualified nonelective contributions (QNECs) eligible to be included in the nondiscrimination testing for elective deferrals (the ADP test) or in the nondiscrimination testing for matching or after-tax employee contributions (the ACP test) must be subject to 100 percent immediate vesting.[6]

Employer Contributions under SIMPLE 401(k) Plans

To satisfy the requirements of a SIMPLE 401(k) plan under IRC §401(k)(11), an employer must make either a nonelective contribution or a matching contribution.[7] Employer contributions under a SIMPLE plan must be subject to 100 percent immediate vesting, regardless of whether they are nonelective contributions or matching contributions.[8]

Certain Matching Contributions and Nonelective Contributions under a Safe Harbor 401(k) Plan

In a safe harbor 401(k) plan under IRC §401(k)(12), the employer makes either a safe harbor matching contribution or a safe harbor nonelective contribution.[9] These safe harbor contributions are subject to 100 percent immediate vesting.[10]

Exception for Nonsafe Harbor Contributions

The 100 percent immediate vesting rules do not apply to any matching or nonelective contributions made to a safe harbor 401(k) plan that are not used to satisfy the safe harbor requirements. The rules apply only to the contributions used to satisfy the safe harbor requirements, rather than the plan as a whole. A vesting schedule may be applied to any nonsafe harbor matching or nonelective contributions, if desired.

[5] IRC §410(a)(1)(B).
[6] IRC §401(k)(3)(D)(ii)(I) (QMACs), and IRC §§401(k)(3)(D)(ii), and 401(m)(4)(C)(QNECs).
[7] IRC §401(k)(11)(B).
[8] IRC §401(k)(11)(A)(iii).
[9] IRC §401(k)(12)(B) or (c).
[10] IRC §401(k)(12)(E)(I).

Exception for Qualified Automatic Contribution Arrangement (QACA)

The immediate vesting requirement does not apply to safe harbor contributions made to an alternative safe harbor plan under IRC §401(k)(13) that satisfies the conditions to be a QACA. QACAs are discussed in *The DC-2 Study Guide: 401(k) Plans and Intermediate Administration Topics*, available through the ASPPA bookstore at ecommerce.asppa-net.org.

If You're Curious . . .

Deemed IRAs

Deemed IRA contributions are voluntary employee contributions that are made to a qualified plan and designated by the employee to be treated as IRA contributions (traditional or Roth). These contributions are permitted for plan years beginning after December 31, 2002.[11] Deemed IRAs must be subject to 100 percent immediate vesting because they are treated as IRAs for purposes of the tax code and IRAs must be nonforfeitable.[12]

ESOP Dividends Reinvested by Employee Election

IRC §404(k) allows a corporation to take a tax deduction for certain dividends paid on employer securities held by an ESOP. The dividend deduction is still available even if the ESOP gives participants an election between receiving payment of the dividends or to have such dividends reinvested in the plan in the form of employer securities.[13] Any dividends reinvested pursuant to such an election must be 100 percent vested, even if the participant is not otherwise 100 percent vested under the plan's vesting schedule.[14]

HOW THE VESTING PERCENTAGE APPLIES TO THE ACCRUED BENEFIT

The applicable vesting percentage at any point in time is multiplied by the accrued benefit to determine the amount of the employee's **vested benefit** at that time. In a defined contribution plan, the accrued benefit is the value of the employee's account balance.

EXAMPLE 9-4. Application to Account Balance Under Defined Contribution Plan. A profit sharing plan provides for the six-year graded vesting schedule. As of the last day of the current plan year, Jason has three years of service credited for vesting purposes. His vesting percentage is 40 percent. The value of Jason's account balance as of the last day of the plan year is $40,000. Jason's vested accrued benefit is $16,000, determined by multiplying $40,000 by 40 percent.

Separate Accounting may be Required

The plan might include contributions that must be 100 percent vested at all times. As discussed earlier, these contributions may include pre-tax elective contributions under a 401(k) arrangement (including catch-up contributions), designated Roth contributions (including catch-up contributions), after-tax employee contributions, safe harbor matching contributions or safe harbor employer nonelective contributions. In that case, the vesting percentage under the plan's

[11] IRC §408(q).
[12] IRC §408(a)(4) and (b)(4) (nonforfeitability requirement for traditional IRAs) and IRC §408A(a) (which treats Roth IRAs as traditional IRAs for all purposes except as specifically provided in IRC §408A).
[13] IRC §404(k)(2)(A)(iii).
[14] Notice 2002-2, Q&A-9 and IRC §404(k)(7).

vesting schedule will apply only to the portion of the accrued benefit or account balance that does not include these contributions.

EXAMPLE 9-5. 401(k) Arrangement. Assume in EXAMPLE 9-4 above that the profit sharing plan includes a 401(k) arrangement. Of the $40,000 total value in Jason's account balance, $10,000 represents his elective contributions (and earnings on those elective contributions). Jason's vesting percentage applies only to the remaining $30,000. Jason's vested account balance now totals $22,000, determined by multiplying $30,000 by 40 percent, to get $12,000, then adding the $10,000 of accumulated elective contributions that are 100 percent vested.

Different Schedules May Apply to Different Contributions

A similar issue arises when the plan provides a separate vesting schedule for certain contributions. This is more common in 401(k) plans. For example, the plan may provide a vesting schedule for matching contributions that is different from the vesting schedule that applies to other employer contributions (e.g., profit sharing contributions). The vested accrued benefit will be the sum of the amounts determined under these separate calculations.

EXAMPLE 9-6. Different Vesting Rules for Matching Contributions and Nonelective Contributions. A 401(k) plan provides for matching contributions and for employer nonelective contributions. Matching contributions are subject to a four-year vesting schedule, which starts with 25 percent vesting following completion of one year of service, and increases by 25 percent for each additional year of service. The nonelective contributions are subject to the statutory six-year graded vesting schedule.

Reese has three years of service for vesting purposes. His account balance consists of the following values:

Elective contributions:	$8,000
Matching contributions:	$2,500
Nonelective contributions:	$1,300

Each of the separate values represents the type of contribution shown, as adjusted for net investment earnings and losses. Under the vesting schedule that applies to the matching contributions, Reese is 75 percent vested. Under the vesting schedule that applies to the nonelective contributions, Reese is 40 percent vested. The value of the vested portion of Reese's account is $10,395. This total represents the entire value of the elective contributions ($8,000), which must be 100 percent vested at all time, plus 75 percent of the value of the matching contributions ($1,875) plus 40 percent of the value of the nonelective contributions ($520).

If You're Curious . . .

Special Vesting Formula when Certain Distributions are Made from Partially-Vested Account Balances

If a defined contribution plan makes a distribution from an account balance at a time when that account is less than 100 percent vested, separate accounting is required to properly apply the vesting schedule to the remaining benefit.[15] If the participant is not vested and the plan permits immediate forfeiture, nothing will remain of the account after that forfeiture, so separate accounting is not necessary.

[15] Treas. Reg. §1.411(a)-7(d)(5).

Two Alternative Formulas Prescribed

The regulations provide two formulas for satisfying the separate accounting rule, one of which must be designated by the plan.

$$\text{Formula 1: } X = P\,[AB + (R \times D)] - (R \times D).$$
$$\text{Formula 2: } X = P\,(AB + D) - D.$$

The variables in the formula mean the following:

X is the employee's vested portion of any amount remaining in the plan at the time that the employee's vesting percentage is being determined,

P is the employee's vesting percentage under the normal schedule at the time that the vested interest is being determined (i.e., the current vested percentage),

AB is the value of the account balance remaining in the plan at the time that the vested interest is being determined (i.e., the current value),

D is the amount distributed, and

R is the ratio of the current value of the remaining account balance over the value of the account balance immediately after the distribution.

Purpose of Special Formula

The purpose of the formula is to prevent an overstatement of the employee's vested account balance. For example, assume an employee has a $10,000 account balance and is 60 percent vested (i.e., the vested account balance is $6,000). The employee withdraws $2,000 of his vested benefit, leaving a $4,000 vested benefit behind. Immediately after the distribution, the account is reduced to $8,000. If the 60 percent vesting percentage is applied to the remaining account balance, the employee's vested amount would be $4,800 in that remaining account balance, as opposed to the $4,000 remaining vested benefit. The special vesting formula takes into account that the employee has already received $2,000 of his vested interest.

If, on the other hand, Formula 1 is applied, the vested interest after the $2,000 distribution is made would be calculated as follows:

$$X = P\,[AB + (R \times D)] - (R \times D)$$
$$X = 60\%\,[\$8{,}000 + (\$8{,}000 / \$8{,}000 \times \$2{,}000)] - (\$8{,}000 / \$8{,}000) \times \$2{,}000)$$
$$X = 60\%\,[\$8{,}000 + (1 \times \$2{,}000)] - (1 \times \$2{,}000)$$
$$X = 60\%\,[\$8{,}000 + \$2{,}000] - \$2{,}000$$
$$X = \$6{,}000 - \$2{,}000$$
$$X = \$4{,}000$$

The formula, therefore, correctly determines the remaining $4,000 vested benefit.

If Formula 2 is applied, the vested interest would be determined as follows:

$$X = P\,(AB + D) - D$$
$$X = 60\%\,(\$8{,}000 + \$2{,}000) - \$2{,}000$$
$$X = 60\%\,(\$10{,}000) - \$2{,}000$$
$$X = \$6{,}000 - \$2{,}000$$
$$X = \$4{,}000$$

If the account balance is 100 percent vested, a special vesting formula is not needed, even if only part of the account is withdrawn, because everything remaining is 100 percent vested.[16]

[16] Treas. Reg. §1.411(a)-7(d)(5)(i)(A).

Either formula will still properly determine the correct vested interest, even if investment earnings and/or contributions are added to the remaining account balance. AB would be greater, reflecting the increases in the participant's account. The variable R in Formula 1, the ratio of the full current account to the account at the time of the distribution, will cease to equal 1, as it did in the above example. The changes in these variables will permit the formula to calculate the remaining vested interest properly.

Section 9.04: Measuring a Year of Service for Vesting

DEFINITION OF YEAR OF SERVICE

A plan may measure a year of service either by using a counting-hours method or an elapsed time method. The method the plan will use to determine vesting must be specified in the plan document.

Counting-Hours Method

In the **counting-hours method**, the plan counts hours of service to determine vesting. The plan administrator must track participants' hours of service in a **vesting computation period**. A year of service is earned when a participant is credited with at least 1,000 hours of service during a vesting computation period,[17] although the plan may be written to require fewer than 1,000 hours for a year of service. The majority of plans with vesting schedules use the counting-hours method to determine years of service under the vesting schedule.

Elapsed Time Method

Under the **elapsed time method**, hours of service are not counted and there are no vesting computation periods to measure. Instead, the plan administrator calculates the employee's **period of service**, as defined under the elapsed time rules. A participant attains a year of service for vesting purposes for each one-year period of service.

Easier for Part-Timers to Satisfy Vesting Requirements

Under the elapsed time method, an employee can earn years of service regardless of the number of hours of service that would have been credited. If an employer would rather minimize the number of part-time employees that fully vest under the plan, it should consider using the counting-hours method instead of the elapsed time method. A part-time employee might have fewer years of service for vesting purposes if, instead of using elapsed time to determine service, the plan defined a year of service as 1,000 hours of service in a vesting computation period.

Service Spanning Rule

Although elapsed time looks at periods of employment, certain absences are disregarded and the employee is deemed to be in service during such periods. For example, absences of less than 12 months, regardless of the reason for the absence, are treated as if the employee was employed during that absence. This rule (known as the **service-spanning rule**) makes the elapsed time method ineffective in excluding seasonal employees. Depending on the seasonal employee's work schedule, a service requirement of 1,000 hours may prevent the employee from earning vesting credits.

EXAMPLE 9-7. Seasonal Employee. Butch is a seasonal employee and his employment commencement date is May 1, 2017. He works from May through August and from November through January.

[17] IRC §411(a)(5)(A); ERISA §203(b)(2)(A).

The plan has a three-year cliff vesting schedule and uses the elapsed time method to credit service.

Because Butch's two absences (from September 1, 2017 to October 31, 2017 and from February 1, 2018 through April 30, 2018) were less than 12 months, the absence periods are treated as continuous employment under the service-spanning rule. Therefore, Butch is credited with one year of service for vesting purposes as of April 30, 2018 because of his continuous periods of service from May 1, 2017 through April 30, 2018.

EXAMPLE 9-8. Comparison to Counting-Hours Method. Suppose the plan in the prior **EXAMPLE 9-7** used the counting-hours method instead of elapsed time, and required at least 1,000 hours of service in a vesting computation period for a year of service. Also assume the vesting computation period is defined to be the plan year (January 1 through December 31).

Butch's initial vesting computation period runs from January 1, 2017 through December 31, 2017. During that period he is credited with 70 hours per month in six months (May, June, July, August, November and December) for a total of 420 hours. Butch would not be credited with a year of service for vesting for the 2017 plan year. In addition, if this work schedule and the number of hours of service per month continued without modification, Butch would never earn any years of service for vesting purposes under the counting-hours method because he would never complete at least 1,000 hours of service during a plan year.

VESTING COMPUTATION PERIOD

The vesting computation period used with the counting-hours method must be a period of 12 consecutive months. The period can be any uniform period applicable to all employees, regardless of when they commence employment. Most plans designate the plan year as the vesting computation period. Unlike the eligibility computation period, an employee's first computation period does not have to begin on his or her employment commencement date.

EXAMPLE 9-9. Counting Hours in a Vesting Computation Period. A profit sharing plan defines the vesting computation period to be the plan year. The plan year is the calendar year. Frank is hired on July 7, 2017. Frank's initial vesting computation period is January 1, 2017 through December 31, 2017, which is the plan year in which he is first credited with an hour of service. This is true even though Frank was not employed by the employer before July 7. If, for the 2017 plan year, Frank is credited with at least 1,000 hours of service, he also is credited with a year of service for vesting purposes, even though he is employed for less than six months during 2017. On January 1, 2018, Frank commences his second vesting computation period.

EXAMPLE 9-9 above illustrates a good practice tip. To determine the number of years of service for vesting purposes for an employee when the plan uses the counting hours method, follow these steps:

- Identify the vesting computation period. This will always be a 12-month period.
- Look at the vesting computation period in which the participant's date of hire falls. Did the participant complete more than 1,000 hours (or whatever the hours requirement is for the plan at issue) during that 12-month period? If so, credit the employee with a year of vesting service. If not, do not credit a year.
- Look at each subsequent vesting computation period through either the end of the plan year at issue (if you are evaluating vesting for a given plan year for administration purposes) or the end of the vesting computation period in which the participant terminated employment (if you are determining a distribution payment for a terminated individual). Ask the same question for each period: did the participant complete at least 1,000 hours of service during that 12-month period? Credit one year of vesting service every time the answer is "yes."

- Total the number of years for which the answer to the question was "yes"; those are the years of vesting service.

Using Employment Years as the Vesting Computation Period

The plan may define the vesting computation period with reference to the employee's employment commencement date (ECD). Under this approach, the initial period is the 12-month period commencing on the ECD and subsequent periods are the 12-month periods commencing on each anniversary of the ECD. The primary drawback to this approach is that each employee has a different vesting computation period, based on his or her particular ECD. This means that the employer and plan administrator will need to accumulate and keep hours of service records based on a different computation period for each employee – a daunting administrative task.

EXAMPLE 9-10. Employment Year as Vesting Computation Period. Assume in **EXAMPLE 9-9** above, the plan measures the vesting computation period on the basis of employment years. Frank's initial vesting computation period would begin July 7, 2017 and end July 6, 2018. Frank's subsequent vesting computation periods would begin every July 7.

Administration Simplified by Using Plan Year as the Computation Period

Defining the vesting computation period as the plan year simplifies plan administration because the plan year is the primary administrative period of the plan. Typically, the plan will track hours of service for the plan year to determine who qualifies for plan allocations or benefit accruals. If the vesting computation period is the plan year, the hours of service tracked for the plan year are used for both purposes—benefit accrual and vesting. In addition, many plans shift the eligibility computation period to the plan year after the initial period required by the regulations. Therefore, by the employee's second eligibility computation period, the plan year is serving as the measuring period for eligibility service, vesting service and accrual service.

If You're Curious . . .

Amendments to the Vesting Computation Period

The vesting computation period may not be a period of less than 12 months. If there is an amendment to the vesting computation period, a short vesting period of less than 12 months cannot be created.[18] Because the vesting computation period must run for a full 12 months, the 12-month computation period beginning on the first day of the previous vesting computation period will overlap with the next vesting computation period, as measured on the basis of the new period. The plan may use the short period as the computation period only if it prorates the hours of service requirement and the overlapping period alternative is provided to employees who cannot satisfy the prorated hours requirement.

EXAMPLE 9-11. Change in Vesting computation Period. A plan defines the vesting computation period as the plan year that ends June 30. Martha is in her fourth vesting computation period, which started July 1, 2017. Effective January 1, 2018, the employer amends the plan year to a calendar year creating a short plan year from July 1, 2017 through December 31, 2017.

Martha's computation period will run for the full 12 months from July 1, 2017 through June 30, 2018, even though the short plan year ends December 31, 2017. Martha's fifth vesting computation period begins January 1, 2018 (i.e., the plan year that begins within the prior vesting computation period) and ends December 31, 2018, coinciding with the amended plan year period.

[18] DOL Reg. §2530.203-2(c).

Therefore, from January 1, 2018 through June 30, 2018, Martha's fourth and fifth computation periods overlap, and hours credited in that six-month period count in both vesting computation periods. If Martha completes 1,000 hours of service in both computation periods (i.e., July 1, 2017 through June 30, 2018 and the 2018 calendar year), she will be credited with two years of vesting service.

EXAMPLE 9-12. Short Vesting Cmputation Period Alternative. Suppose in the prior **EXAMPLE 9-11** that the plan provided for a short vesting computation period running from July 1, 2017 to December 31, 2017—a six-month period. A year of service is credited for that short period if an employee completes at least 500 hours of service (i.e., one-half the normal hours requirement to reflect the six-month length of the vesting period). For the short period from July 1, 2017 to December 31, 2017, Martha is credited with only 400 hours. From January 1, 2018 through June 30, 2018, she is credited with 620 hours. Under the prorated hours requirement for the short period, Martha would fail to get credit for a year of service with respect to the short vesting period that starts July 1, 2017. However, the prorated hours requirement is an allowable provision only if the plan provides an alternative that credits a year of service if an employee completes at least 1,000 hours of service for the 12-month period starting July 1, 2017 and ending June 30, 2018. Accordingly, Martha would still get credit for a year of service for that 12-month vesting period.

The overlapping computation period rule described above would apply only to a participant who has at least one hour of service during the short period. An employee who is hired after the end of the short period is not affected by the amendment, and may have his or her vesting computation periods determined solely by the amended provisions of the plan. In **EXAMPLE 9-12** above, an employee who is hired during 2018 would have his or her first vesting computation period measured from January 1 through December 31, 2018.

Initial Short Plan Year

The short computation period issue arises not only when the vesting computation period is amended but if a new plan has an initial short plan year and the vesting computation period is defined to be the plan year. When the effective date of a new plan is a date other than the first day of the normal plan year cycle, the plan will start with an initial plan year of less than 12 months. However, a vesting computation period may not be a period of less than 12 months. If the plan recognizes service before the plan's effective date for vesting purposes, then the initial short plan year will not have any effect, because the vesting computation period which includes the effective date of the plan will be the 12-month period ending on the last day of the first plan year. If the plan disregards service before the plan's effective date, the initial short plan year may not be used as a vesting computation period. The initial short plan year will be treated in the same way as an amendment of the vesting computation period. The first 12-month vesting computation period will start on the effective date of the plan, and overlap with the second plan year.

EXAMPLE 9-13. New Plan Does Not Disregard Pre-Plan Service. A profit sharing plan is established with an effective date of July 1, 2017. The plan year ends December 31; therefore, the first plan year is a six-month period running from July 1, 2017 to December 31, 2017. The plan does not disregard service before the effective date of the plan to determine vesting service and defines the vesting computation period to be the plan year. Because service before July 1, 2017 is counted, the initial short plan year has no effect on the calculation of vesting service. The period January 1, 2017 to December 31, 2017 constitutes a vesting computation period, even though the

effective date of the plan falls in the middle of that vesting computation period. The 12-month plan year periods prior to January 1, 2017 are also taken into account.

EXAMPLE 9-14. New Plan Disregards Pre-Plan Service. If, in the prior **EXAMPLE 9-13**, the plan document does disregard service before the effective date of the plan, then service before July 1, 2017 is disregarded. The plan may start the first 12-month vesting computation period on July 1, 2017 which runs through June 30, 2018. The second vesting computation period will start on January 1, 2018 and run through December 31, 2018. Thus, the first and second vesting periods overlap for the first six months of 2018. Thereafter, vesting periods are measured on the calendar year, which coincides with the plan year.

EXAMPLE 9-15. New Plan Disregards Pre-Paln Service—Alternate Approach. A plan may disregard only some of the service prior to the plan's effective date.[19] Accordingly, the plan in the prior **EXAMPLE 9-14**, with an effective date of July 1, 2017 may disregard service before January 1, 2017 and treat calendar year 2017 as a vesting computation period, even though the effective date of the plan falls in the middle of that period. Under this alternative, the plan in effect is disregarding service that occurs more than six months before the effective date of the plan.

Employer Not in Existence for an Entire Vesting Period

When an employer comes into existence during the initial 12-month vesting computation period, it should be reasonable to assume a valid 12-month vesting computation period ends on the last day of the initial short period, even though neither the IRS nor the DOL has addressed this issue. It is a similar situation to one where new employees are hired during a vesting computation period.

EXAMPLE 9-16. Company Formed Mid-Year. A plan measures vesting periods on a plan year basis. The plan year ends December 31. The plan counts service before the effective date of the plan. The plan is effective January 1, 2018. The company was formed two years earlier on May 1, 2016. When determining service prior to the establishment of the plan, it should be reasonable to treat the 2016 vesting computation period as a 12-month period ending December 31, 2016 even though no employees were credited with hours of service before May 1, 2016. Because there is no definitive guidance for this issue, a more conservative approach would be to start a 12-month vesting period on May 1, 2016 and then shift the calendar year period starting January 1, 2017 as if the vesting period were amended.

Employment Year Periods Avoid Short Plan Year Issues

If a plan uses the employee's employment year as the vesting computation period, these issues of short plan years are avoided. In **EXAMPLE 9-16** above, employees who start work on May 1, 2016, when the company is established, would start their first vesting computation period on that date, and all subsequent periods would start on the anniversary of that date. The disadvantage to this approach is that each employee has a different computation period, thereby complicating the plan administration.

[19] IRC §411(a)(4)(c)

Service with Predecessor Employer

In some cases, the plan may credit service with a predecessor employer for vesting purposes. In such cases, the predecessor service would be taken into account to measure the relevant 12-month vesting computation periods.

CONTINUOUS EMPLOYMENT NOT REQUIRED

The 12-month vesting computation period requirement does not mean that an employee must be employed continuously during that 12-month period. In fact, the employee does not even have to be employed on the last day of the computation period to receive credit for the year of service. All that is necessary is that the employee complete the necessary hours of service required by the plan during that vesting computation period. Compare this to the elapsed time method of crediting service, where a minimum number of hours of service in a computation period is not required, and employment periods are measured instead.

EXAMPLE 9-17. Layoff for Portion of Vesting Period. A plan's vesting computation period is the plan year. The plan year is the calendar year. On March 10, 2017, Peter is laid off. On August 6, 2017, he is rehired. Although Peter is not employed continuously from January 1, 2017 through December 31, 2017, his vesting computation period is still measured on that basis. If he is credited with at least 1,000 hours of service during his periods of employment in the 2017 plan year, the plan must credit Peter with a year of service for vesting purposes if it opts to use the counting-hours method.

EXAMPLE 9-18. Seasonal Employees. Corporation X hires seasonal employees. The employees usually work from March through June and from September through December. Sharon, a seasonal employee, works from March 8, 2017 through June 28, 2017 and is credited with 550 hours of service for that period. Sharon recommences employment for the next seasonal period on September 10, 2017 and works through December 20, 2017. During the second period of employment, she is credited with 480 hours of service. Sharon does not recommence employment until March 16, 2018. For the vesting computation period measured from January 1, 2017, through December 31, 2017, Sharon is credited with 1,030 hours of service. If it opts to use the counting-hours method, the plan must credit Sharon with one year of service for vesting purposes, even though she is not actually employed for the entire 12-month period or even on the last day of the computation period.

Consecutive Months

It is common to see the plan define the vesting computation period to be a 12-consecutive-month period, and then define the year of service as 1,000 or more hours in such period. The use of the phrase **12-consecutive-month period** is usually required by IRS reviewers looking at the language of the plan before issuing an approval letter (e.g., determination letter) to clarify that the statutory year of service definition requires the employee to complete all 1,000 hours within 12 months that are consecutive. In other words, if a vesting computation period starts April 1, then it ends March 31. The use of the word "consecutive" does not mean that the employee must be employed continuously during that 12-month period.

EXAMPLE 9-19. 12-Consecutive-Month Computation Period. Neil's employment commencement date is May 1, 2017. The plan defines a vesting computation period as the plan year, which ends every December 31. Neil only works certain months of the year. He earns 100 hours in May, June and July 2017, November and December 2017, January and February 2018, and May, June and July 2018.

Although Neil's hours at the end of July 2018 total 1,000, and he completed those hours in only ten different months, this is not a statutory year of service, because those months were not part of a

12-consecutive-month vesting computation period. The first vesting computation period in which Neil has hours is the 2017 calendar year. During that period, his hours only total 500. Therefore, Neil does not have credit for a year of service for vesting purposes.

However, if Neil worked at least 1,000 hours in May, June, July, November and December 2017, he would have met the hours requirement for the 2017 vesting computation period, and would be credited with a year of service as of December 31, 2017, even though he did not work for 12 consecutive months.

CREDITING SERVICE FOR VESTING PURPOSES

As a general rule, the plan must count all years of service for vesting purposes, including participants' service before satisfying the plan's eligibility requirements or while suspended from participation in the plan because of employment classification.[20]

EXAMPLE 9-20. Hours in a Vesting Computation Period. Earl commences employment on April 10, 2017. The employer maintains a profit sharing plan. The plan year is the calendar year. An employee becomes a participant on the semiannual entry date (January 1 or July 1) following completion of one year of service. The plan uses the counting-hours method to compute service for vesting purposes. The vesting computation period is the plan year. For the 2017 plan year, Earl is credited with at least 1,000 hours of service. As of December 31, 2017, Earl has one year of service for vesting purposes, even though he is not a participant in the plan as of such date.

If the plan excludes hourly-paid employees and Earl is paid on an hourly basis, then Earl would not become a participant in the plan, but still would earn credited service for vesting. Suppose Earl is an hourly-paid employee until January 1, 2020. At that time, he is promoted to a salaried position and becomes a participant in the plan. When he commences participation on January 1, 2020 he will be credited with three years of service for vesting purposes because he has worked at least 1,000 hours in each of the 2017, 2018 and 2019 vesting computation periods.

If You're Curious . . .

Qualified Separate Lines of Business

Some employers divide the workforce into qualified separate lines of business (QSLOBs), pursuant to IRC §414(r), for coverage and nondiscrimination testing purposes. This permits the employer to test each QSLOB separately for nondiscrimination testing, as if each QSLOB was a single, unrelated company. The fact that an employer relies on QSLOB testing does not affect an employee's right to have service recognized with the entire company, including all QSLOBs. If an employee works for QSLOB-1 and later is transferred to QSLOB-2, his or her prior service with QSLOB-1 must be recognized by QSLOB-2 to determine the employee's vesting rights under the vesting schedule prescribed by QSLOB-2's plan.

Frozen Plans

Service with the employer cannot be disregarded during periods when a plan is frozen. To illustrate, an employer froze its defined benefit plan as of December 31, 1996, but later amended the plan to recommence accrual of benefits, effective January 1, 2003, under a different formula. The IRS ruled that service earned by employees while the plan was frozen (i.e., from 1997 through 2003) must be

[20] Treas. Reg. §1.411(a)-5(a).

counted toward determining a participant's vested percentage in his or her post-2002 accruals under the new formula. The IRS also noted that the same result would apply if a new plan was established and the frozen plan was merged into the new plan.[21]

Years that may be Excluded

Certain years of service may be excluded in determining an employee's vesting percentage.[22] These exclusions are not applicable unless specified in the plan. If the plan uses the elapsed time method for crediting service, the exclusions would apply to periods of service (rather than years of service) in which the conditions for the exclusion exist.

Exclusion of Service When Plan (or Predecessor Plan) Was Not Maintained

The plan may disregard years of service during any period for which the employer did not maintain the plan or a predecessor plan.[23] A plan is treated as established on the first day of the plan year in which the plan is adopted, even though the plan is adopted after the first day of such plan year.[24] For example, if a plan is adopted on August 10, 2018, with an effective date of January 1, 2018, the plan is treated as established on January 1, 2018, for purposes of this rule. The plan also may disregard any period after a plan is terminated.

If You're Curious…

When there is a predecessor plan, service with respect to periods during which such predecessor plan was maintained may not be disregarded under this rule. A predecessor plan is a qualified plan that is terminated within the five-year period before or after the establishment of another plan (the successor plan).[25] Service credited to an employee who was covered by the predecessor plan must be credited under the successor plan.[26] For an employee who was covered by the predecessor plan, service for the new plan will include years of service under the predecessor plan provided that the employee's years of service under the predecessor plan are not equaled or exceeded by the number of consecutive one-year breaks in service occurring after the later of the time the predecessor plan is terminated or the successor plan is established.[27] Years between the termination date of the predecessor plan and the establishment of the successor plan do not count as years of service. The definition of a predecessor plan for this purpose is limited to include only a qualified plan under IRC §401(a). That means that a SEP or a SIMPLE IRA plan would not be a predecessor plan under this rule.

If plans maintained by the same employer are merged, the successor plan is treated as if it were established as of the earliest date that either plan was established.[28] This rule applies even if the plans are maintained by members of the same controlled group or affiliated service group. If the plans are maintained by unrelated employers, the successor plan is treated as if it were established on each of the separate dates on which each component plan was established for the employees of each employer.

EXAMPLE 9-21. No Predecessor Plan. Corporation Y establishes a profit sharing plan effective January 1, 2018. The plan year is the calendar year. Corporation Y has never maintained a qualified plan. The corporation was established in 2008. Martha is one of several employees who

[21] Rev. Rul. 2003-65, I.R.B. 2003-25, June 23, 2003.
[22] IRC §411(a)(4); ERISA §203(b).
[23] IRC §411(a)(4)(C); ERISA §203(b)(1)(C).
[24] Treas. Reg. §1.411(a)-5(b)(3)(ii).
[25] Treas. Reg. §1.411(a)-5(b)(3)(v)(B).
[26] See Treas. Reg. §1.411(a)-5(b)(3)(v)(A).
[27] Treas. Reg. §1.411(a)-5(b)(3)(v)(A).
[28] Treas. Reg. §1.411(a)-5(b)(3)(ii).

have been employed by the corporation since 2008. If the plan counts all years of service, Martha would have at least ten years of service for vesting purposes, resulting in 100 percent vesting under any of the possible vesting schedules. If the plan disregards years of service before the plan was established, the 2018 plan year will be Martha's first year of service for vesting purposes.

EXAMPLE 9-22. Predecessor Plan. Suppose, in the prior **EXAMPLE 9-21**, the corporation had previously maintained a plan that was terminated on December 10, 2016. Because the new profit sharing plan is established within the five-year period after the termination of the prior plan, the prior plan is a predecessor plan for vesting purposes, and service credited for periods during which the predecessor plan was maintained must be counted for employees who were covered by that predecessor plan. If Martha was covered by that predecessor plan, her service during the period the corporation maintained that plan would count toward vesting in the new profit sharing plan.

EXAMPLE 9-23. Two Plans Maintained By Same EmployerEmployer X maintains Plan A and Plan B. Plan A was established effective January 1, 2018, and provides for three-year cliff vesting. Plan B was established effective January 1, 2005. Employer X merges Plan A and Plan B, forming Merged Plan C. Prior to the merger, Plan A did not credit service before January 1, 2018 (i.e., the effective date of the plan). However, years of service under Merged Plan C must be credited from the earliest date that any component plan was established (i.e., January 1, 2005, which is the date Plan B was established). This is true for all of the participants, regardless of whether they were previously covered by Plan A or Plan B. Accordingly, all participants are credited service earned on or after January 1, 2005 to determine their vested rights under Merged Plan C, even if they were previously participants in only Plan A.[29]

EXAMPLE 9-24. Plans Maintained By Unrelated Emlpoyers. Employer X maintains Plan A and Employer Y maintains Plan B. Employers X and Y are not related employers. Plan A was established effective January 1, 2018, and Plan B was established effective January 1, 2005. The plans are merged, forming Merged Plan C. If Merged Plan C elects to exclude service prior to plan inception for vesting purposes, Merged Plan C must still credit service with Employer Y from January 1, 2005 for the employees previously covered under Plan B. However, service with Employer X need only be credited from January 1, 2018 (Merged Plan C's inception date) for the employees formerly covered under Plan A.

EXAMPLE 9-25. Prior Plan Not Terminated. Corporation X maintains a money purchase plan that uses a six-year graded vesting schedule. Effective January 1, 2018, Corporation X adopts a profit sharing plan, but does not terminate the money purchase plan. The profit sharing plan provides that service before the effective date is excluded. Service before January 1, 2018 is not taken into account in determining an employee's vesting rights under the profit sharing plan, even if the employee is a participant in the money purchase plan.

Disregarding Service Before Age 18

Service credited before an employee reaches age 18 may be disregarded by the plan.[30] If an employee's 18th birthday

[29] See, PLR 200337015.

[30] IRC §411(a)(4)(A); ERISA §203(b)(1)(A).

falls during a vesting computation period, a year of service credited for that period must be counted.[31] If the plan uses the elapsed time crediting method, the effect of this rule is to treat the employee's 18th birthday as the date the elapsed time period begins.

Coordination with age-21 eligibility rule. Do not confuse this rule with the age-21 requirement for eligibility. A plan may require an employee to reach age 21 before he or she can become a participant, but service credited after age 18 must be counted for vesting purposes (unless another exclusion applies), even if the employee was not eligible to participate.

Exclusion of Service Because of Break-in-Service Rules

When an employee has a break in service, he or she may lose credit for prior years of service for vesting purposes. A break in service also might result in certain future years of service having limited effect for vesting purposes.[32] Loss of credit for prior service may be temporary or permanent. This is discussed further below.

If You're Curious . . .

Contributory Plans May Disregard Years in Which Eligible Participants Declined to Participate

A plan is a contributory plan if it requires employees to contribute on an after-tax basis. Contributory plans may be defined benefit plans or defined contribution plans. If an employee is required to contribute to the plan, but does not make the required contribution, the plan may disregard service for the period during which the contribution is required but not made.[33] If the employee is not eligible to participate in the plan for other reasons (e.g., has not satisfied the minimum age and service requirements, or is in an excluded employment classification), the plan may not disregard service during such periods in determining the employee's vesting percentage.[34]

A plan may not disregard service for vesting purposes merely because an employee does not elect to make elective contributions under a 401(k) plan. Also, some plans permit employees to make after-tax employee contributions on a voluntary basis. Service may not be disregarded for vesting purposes merely because an employee has declined to take advantage of the voluntary after-tax employee contribution feature in the plan. Although designated Roth contributions are contributed on an after-tax basis, they are elective contributions and treated under the plan in the same manner as pre-tax 401(k) contributions. Thus, this exception for disregarding certain years of service would not apply to a participant who fails to make designated Roth contributions.

EXAMPLE 9-26. Years in Which Participant Declined to Make Required After-Tax Employee Contributions. A profit sharing plan requires employees to contribute 4 percent of compensation per year. If the employee makes the required contribution, the employer matches the contribution 50 cents on the dollar. Mabel first becomes eligible for the plan on July 1, 2014. The plan year begins every July 1. A vesting schedule applies to the matching contributions and to any discretionary contributions made by the employer to the profit sharing plan. The plan defines the vesting computation period as the plan year. The plan disregards service for any period an employee does not make the required contributions. For the plan year beginning July 1, 2017, Mabel declines to make the 4 percent required contribution. Although Mabel is credited with at least 1,000 hours of service during that plan year, she is not credited with a year of service for the July 1, 2017, through June 30, 2018, plan year for vesting purposes because she did not make the required contribution.

[31] Treas. Reg. §1.411(a)-5(b).

[32] IRC §§411(a)(4)(D) and 411(a)(6); ERISA §§203(b)(1)(D) and 203(b)(3).

[33] IRC §411(a)(4)(B); ERISA §203(b)(1)(B).

[34] Treas. Reg. §1.411(a)-5(b)(2).

If the employee makes any part of the required contribution, the year of service may not be disregarded.[35] If, in the prior **EXAMPLE 9-26**, Mabel contributed 2 percent of compensation, she must receive credit for a year of service for that vesting computation period.

Special Rules for Multiemployer Plans

There are three exceptions crediting years of service in multiemployer plans relating to withdrawals from or terminations of a multiemployer plan. (Multiemployer plans are those that are sponsored by unions, cover employees of more than one company, and meet a series of other requirements).

Complete withdrawal by employer. If an employer has a complete withdrawal from a multiemployer plan, years of service with the employer after such complete withdrawal may be disregarded by the multiemployer plan.[36] A complete withdrawal occurs when the company is no longer contributing to the plan, usually in connection with a decertification of the union.[37]

Partial withdrawal by employer. In the case of an employer's partial withdrawal from a multiemployer plan, in conjunction with the decertification of the collective bargaining representative, years of service with the employer after such partial withdrawal also may be disregarded by the multiemployer plan, but only to the extent permitted under the regulations.[38]

Termination of the plan. Service with the employer after the termination date of a multiemployer plan may be disregarded by the multiemployer plan.[39]

Section 9.05: Rehired Employees and Breaks in Service

This section discusses the impact of a break in service on an employee's vesting. The break-in-service rules primarily affect employees who are rehired by an employer after a previous termination of their employment. After an employee is rehired, his or her vesting rights in the plan might change, due to years of service that are earned after the rehire date. The break in service may affect the status of the employee's service credits that were earned during his or her original period of employment in relation to benefits earned after the employee returns. The break-in-service rules also may affect whether the employee can increase vesting rights in benefits that accrued with respect to the original period of employment.

EFFECT OF TERMINATION OF EMPLOYMENT ON VESTING RIGHTS

Determination of Vesting at the Time Employment Terminates

Under the counting-hours method, continuous employment for the vesting computation period is not required, nor is employment on the last day of the vesting computation period. If the employee is credited with at least 1,000 hours of service during the computation period in which his or her employment terminates, he or she is credited with another year of service.

EXAMPLE 9-27. Vesting Service in Year of Termination. The vesting computation period is the calendar year. Paul has three years of service as of December 31, 2017. Under the plan's vesting

[35] Treas. Reg. §1.411(a)-5(b)(2).
[36] IRC §411(a)(4)(G)(i)(I); ERISA §203(b)(1)(G)(i)(I).
[37] See, ERISA §4203.
[38] IRC §411(a)(4)(G)(i)(II); ERISA §203(b)(1)(G)(i)(II).
[39] See IRC §411(a)(4)(G)(ii)/ERISA §203(b)(1)(G)(ii). See, ERISA §4048 regarding termination of multiemployer plans.

schedule (six-year graded), Paul is 40 percent vested. Paul terminates employment on June 8, 2018. From January 1, 2018, to June 8, 2018, Paul is credited with 1,150 hours of service. Paul is credited with his fourth year of service because he has more than 1,000 hours in the vesting computation period that coincides with the 2018 calendar year, and advances to 60 percent on the vesting schedule.

Hours of service might need to be credited with respect to compensation paid to the terminated employee after his or her termination date. Suppose in **EXAMPLE 9-27** that Paul has only 950 hours of service credited through June 8, 2018. However, he is also paid for unused vacation totaling two weeks. The payment of unused vacation entitled Paul to another 60 hours of service credits. Paul now has 1,010 hours of service for the 2018 vesting computation period and is credited with another year of service.

Under the elapsed time method, a plan will determine the number of whole years elapsed through the date of termination to determine an employee's vesting percentage. However, if the employee returns to employment in less than 12 months, the service-spanning rule will treat the employee as having been continuously employed during the absence.[40]

EXAMPLE 9-28. Elapsed Time Vesting Computation in Year of Termination. Assume the facts in the previous **EXAMPLE 9-27**, except the plan uses the elapsed time method. There would be no vesting computation periods used to calculate Paul's years of service. Suppose Paul's employment commencement date was March 1, 2015. Under the elapsed time method, we start from March 1, 2015, and measure through June 8, 2018 (Paul's termination date), disregarding his actual number of hours during that period. This yields only three years and approximately three months. Thus, as of his termination, Paul only has three years of service for purposes of the vesting schedule. However, if he returns to employment within one year of his termination (i.e., before June 8, 2019), his absence will be treated as service under the service-spanning rule, resulting in a fourth year of service credit as of March 1, 2019.

Imoprtance of Vested Percentage

The employee's vesting percentage determines how much of the accrued benefit can be distributed to that employee. If a participant's vested percentage is under-calculated, the plan will owe him or her additional benefits. This complicates plan administration and may cause the plan to violate qualification requirements. If the increase in vesting raises a participant's vested benefit to a dollar amount greater than the forced cash-out limit of $1,000, the plan would have paid a benefit without the participant's consent. Because compliance with the consent requirements is a condition of plan qualification, the employer will need to take corrective action under the IRS's Employee Plans Compliance Resolution System (EPCRS). When preparing to make a distribution available to a terminated participant, the plan administrator must determine whether the participant's vesting percentage has increased with respect to service credited in the year of termination.

Termination of Employment is Not a Forfeiture Event

When an employee terminates employment, the plan may not forfeit the nonvested portion of his or her benefits merely because of the termination.[41]

BREAK-IN-SERVICE DEFINITION

If an employee returns to employment, he or she may receive credit for prior years of service when determining vested percentage in benefits accrued after the employee's return. If an employee was only partially vested upon termination, the break-in-service rules will determine whether the employee's vesting in the benefits accrued at the time of his or her

[40] Treas. Reg. §1.410(a)-7(d)(1).

[41] GCM 39310; FSA 1992-1023-1; Hermann v. E.W. Wylie Corp., 766 F.Supp. 800 D.N.Dak. 1991).

original termination might increase.

How a **break in service** is determined depends on whether the plan uses the counting-hours method or the elapsed time method to determine service for vesting purposes. When a plan uses the counting-hours method, breaks in service are determined on the basis of hours of service credited in a vesting computation period. Under that method, an employee incurs a break in service for vesting purposes if he or she is credited with 500 or fewer hours of service in a vesting computation period.[42] The 500-hour rule is a minimum standard. The plan may be more liberal by defining a break in service using a lesser hours-of-service rule (e.g., 250 hours of service in a vesting computation period), or by not imposing a break-in-service rule.

Under the elapsed time method, a break in service is measured as a **period of severance**.

A termination of employment is not necessary to incur a break in service under the counting-hours method. For example, an employee's work schedule may change so that the employee is credited with 500 or fewer hours of service during a vesting computation period. The employee would have a break in service for that period. If the plan imposes a break-in-service rule, the rule would have the same effect on that employee as it would for a former employee who returns to employment after a break in service.

EXAMPLE 9-29. Break in Service Not Incurred. A plan defines the vesting computation period to be the plan year. The plan year is the calendar year. Fred terminates on August 20, 2018, and returns to work on March 1, 2019. For the 2018 vesting computation period, Fred has 900 hours of service. Fred does not have a break in service for 2018 at the time that he is re-employed in 2019.

EXAMPLE 9-30. Break in Service Incurred. Fred terminates on August 20, 2018, and returns to work on March 1, 2020. For the 2018 vesting computation period, Fred has 900 hours of service. While Fred does not have a break in service for 2018, Fred has zero hours of service in 2019 and incurs a break in service for the 2019 vesting computation period.

EXAMPLE 9-31. Reduced Work Schedule Causes Break in Service. Jan is a full-time employee of a corporation that maintains a profit sharing plan. The vesting computation period is the plan year. The plan year is the calendar year. Effective January 1, 2018, Jan begins a reduced work schedule of 20 hours of service per month. For the 2018 plan year, she is credited with only 240 hours of service. Jan has a break in service as of December 31, 2018.

Leave of Absence Exceptions

The law requires that an employee be given service credit during certain leaves of absence, including maternity and paternity leaves and Family and Medical Leave Act (FMLA) leave.

Maternity/Paternity-Leave Rule

If an employee is on an unpaid leave of absence due to maternity or paternity reasons, the plan must credit the employee with hours of service during that absence (up to a maximum of 501 hours), even though hours of service normally have to be credited only with respect to periods for which an employee is paid. The credit for hours of service under this rule is solely for determining whether the employee has incurred a break in service. These hours do not have to be counted toward a year of service. The maternity/paternity-leave rule relates only to unpaid hours because paid hours are required to be credited under the normal hours of service definition.

Maternity or paternity reasons include the employee's pregnancy, the birth of the employee's child, the placement of an

[42] DOL Reg. §2530.200b-4.

adopted child with the employee and child care by the employee beginning immediately following the birth or placement of the child.[43]

If the plan uses the elapsed time method of crediting service, a severance of service does not occur until the second (rather than the first) anniversary of the first day of absence by reason of maternity or paternity leave.[44]

FMLA Leave

The Family and Medical Leave Act[45] (FMLA) allows employees of an employer to take job-protected, unpaid leave for up to 12 work weeks in any 12 months because the employee is needed to care for a family member with a serious health condition or because the employee's own serious health condition makes the employee unable to perform the functions of his or her job. Employers with at least 50 employees are subject to this rule.[46] FMLA §104 requires that, upon return from FMLA leave, an employee's rights with respect to employment benefits must be restored. Employment benefits include benefits under pension and other retirement plans.

Again, this assumes the FMLA-leave period is unpaid. If the employee is paid for the leave period, the normal crediting rules for hours of service apply. Under the normal crediting rules, hours of service during a paid leave period are counted to determine whether an employee has a year of service during a vesting computation period, as well as whether an employee has a break in service during a vesting computation period.

OPERATION OF THE BREAK-IN-SERVICE RULES

The law provides for three types of break-in-service rules. Each break-in-service rule serves a different purpose.

The one-year break-in-service rule and the rule of parity both apply to limit the crediting of service earned before a participant incurs the break for purposes of determining vesting after the break. In other words, will the years of service earned by the employee before he or she terminated employment be used to determine the vested interest in the account that accumulates after rehire?

The five-year break-in-service rule applies to limit the crediting of service after the break to determine whether vesting is increased due to that post-break service in relation to benefits accrued before the break. In other words, will the years of vesting service earned by the employee after he or she is rehired be used to increase the account that was accumulated before the employee terminated employment?

It is important to remember that these rules are not mandatory. A plan document may be more liberal in the way in which it credits service, and may ignore these break-in-service rules entirely. If that is the case, the employee will be credited with all years of service for vesting purposes and will not lose any credit for service earned before a break.

For purposes of these rules, we will use the term "prior service" to mean the employee's service before he or she terminated employment. "Current service" will mean the employee's service after rehire.

Postponed Credit for Prior Service (One-Year Break-in-Service Rule)

Under the **one-year break-in-service rule**, if an employee incurs at least one break in service, the plan may temporarily disregard the employee's prior service for purposes of determining the employee's vesting in the benefit earned after rehire.[47] The employee will not receive credit for that prior service until after he or she completes another year of service. Once that is accomplished, the employee will be given credit for the prior service with regard to vesting in the account that accumulates after the employee is rehired.

[43] IRC §411(a)(6)(E); ERISA §203(b)(3)(E).
[44] Treas. Reg. §1.410(a)-9.
[45] 29 U.S.C. §2612.
[46] FMLA §2611(4)(A)(i).
[47] IRC §411(a)(6)(B); ERISA §203(b)(3)(B).

The effect of this rule is to postpone credit for the prior service during a waiting period. During the time credit is postponed, the employee is treated as not having any service for vesting purposes. When the employee completes another year of service following the break in service, the plan must re-credit the prior service to determine the employee's vesting percentage.

EXAMPLE 9-32. Vesting Service After Return to Employment. Maggie terminates employment on August 3, 2016. The plan year and the vesting computation period are the calendar year. The plan opts to use the one-year-break-in-service rule to postpone credit for prior service following a break in service. For 2016, Maggie is credited with 1,100 hours of service and her fifth year of vesting service. Maggie does not return to employment until April 15, 2018. Maggie has a break in service for the vesting computation period that ended December 31, 2017, because she is credited with zero hours of service during that period.

She returns during the vesting computation period which begins January 1, 2018. If she is credited with at least 1,000 hours of service during 2018, she satisfies the year of service requirement and her service before her break is re-credited to her. If not, the plan will look to the next vesting computation period (i.e., calendar year 2019), and so on, until Maggie is credited with 1,000 hours of service in a vesting period. If Maggie terminates employment before she completes a year of service after her rehire, she will be zero percent vested in any employer contributions (and earnings on such contributions) that are added to her account after her rehire.

EXAMPLE 9-33. Additional Year Completed in First Vesting Period Following Return. Andrea terminates employment on November 5, 2015. She has four years of service for vesting purposes. The plan uses the six-year graded vesting schedule. The plan year is the calendar year. The plan uses the one-year break-in-service rule to postpone credit for prior service following a break in service. Andrea returns to work for the same employer on May 1, 2018.

For the 2016 and 2017 vesting periods, Andrea has zero hours of service, so she has two breaks in service before she is re-employed by the company. Because she has at least one break in service, the one-year break-in-service rule applies. Andrea must complete one year of current service to receive credit for her prior vesting service.

For the 2018 vesting computation period, Andrea is credited with 1,200 hours of service. (The vesting computation is still measured on the basis of the plan year beginning January 1, 2018, and ending December 31, 2018, even though Andrea does not return to employment until May 1 of that year.) Because Andrea earns another year of service in the 2018 plan year, the plan must re-credit Andrea's four prior years of service. As of the end of the 2018 vesting computation period, Andrea has five years of service for vesting purposes.

Note: If Andrea completes only 800 hours of service (rather than 1,200) during the 2018 vesting computation period, the plan would continue to treat Andrea as not having any service for vesting purposes. If she accrues benefits under the plan for 2018, she would be zero percent vested in those benefits. Andrea will not receive credit for the prior years until the first vesting computation period in which she satisfies the 1,000-hour requirement.

Use of Elapsed Time to Determine Service

If the plan provides for the elapsed time method of crediting service, the additional year of service is measured from the re-employment commencement date following the period of severance, using the elapsed time crediting rules.[48]

[48] Treas. Reg. §1.410(a)-7(d)(5).

Benefits Accrued Before the Break Are Not Affected

The one-year break-in-service rule does not affect an employee's vesting percentage in the benefits already accrued (i.e., benefits accrued before the break in service). An employee does not forfeit his or her vested rights simply because he or she has a break in service.

EXAMPLE 9-34. Pre-Break Balance Still in Plan. Suppose in **EXAMPLE 9-33** above, Andrea had an account balance of $15,000 when she left employment in 2015. The account balance is derived solely from employer contributions made to the plan. There is no 401(k) arrangement in the plan. Under the six-year graded vesting schedule, Andrea would be 60 percent vested in that benefit. Suppose the plan does not pay out the vested benefit when Andrea leaves because she does not consent to distribution at that time. When she returns in 2018, her pre-break account balance is worth $18,000. She is still 60 percent vested in that account. When she completes an additional year, she will have five years of service and she will increase to 80 percent vesting. The 80 percent vesting percentage will apply to her entire account balance, including the pre-break account balance.

EXAMPLE 9-35. Pre-Break and Post-Break Vesting Percentages are Different. For any period in which Andrea has pre-break and post-break balances in the plan, and the vesting percentages on those two balances are different, separate accounting will have to be maintained. Suppose in 2018, Andrea fails to complete at least 1,000 hours of service, so she is not re-credited with her pre-break service as of the end of the 2018 plan year. If she is allocated an employer contribution for 2018, the plan will have to maintain a separate accounting of the 2018 allocation from Andrea's pre-break account balance. The pre-break balance is protected at 60 percent vesting, but the post-break balance is zero percent vested until she completes another year of service and gets her pre-break service re-credited.

Rule of Parity

Under the **rule of parity** the employee loses credit for the prior service on a permanent basis following the break-in-service period. As a result, the employee must start over under the vesting schedule with regard to benefits earned after rehire.

For the rule of parity to apply:

- The employee must be a participant when the break-in-service period begins. For this purpose, the employee is a participant if he or she has satisfied the plan's eligibility requirements and has passed his or her applicable entry date under the plan;
- The employee must incur a minimum of five consecutive breaks in service; and
- The employee must be zero percent vested in his or her accrued benefit under the plan at the time that the break-in-service period begins.[49]

If the plan uses the counting-hours method, an employee has five consecutive breaks in service when there are five consecutive vesting computation periods in which the employee is credited with 500 or fewer hours of service in each of those periods. For example, if the vesting computation period is the plan year, then five consecutive breaks in service occur if, for five plan years in a row, a participant has 500 or fewer hours in each of those plan years. If the plan uses the elapsed time method, an employee has five consecutive breaks in service when he or she incurs a period of severance that totals 60 months.

EXAMPLE 9-36. Five Consecutive Breaks in Service Incurred. Ron is a participant in his employer's profit sharing plan that uses three-year cliff vesting. When Ron terminates employment on

[49] IRC §411(a)(6)(D); ERISA §203(b)(3)(D).

May 10, 2012, he has two years of service and is zero percent vested in his account balance. The 2012 calendar year is Ron's third vesting computation period and, when he terminates employment on May 10, 2012, he has completed 600 hours of service for 2012. Therefore, Ron does not have a break in service in 2012.

Ron returns to employment on February 10, 2018. For the computation periods that coincide with the 2013, 2014, 2015, 2016 and 2017 plan years, Ron has no hours of service, resulting in five consecutive breaks in service. If the plan uses the rule of parity, Ron's prior service is permanently disregarded for vesting purposes when he is re-employed on February 10, 2018. If he completes at least 1,000 hours of service during the vesting computation period in which he returns to employment (January 1, 2018 through December 31, 2018), he will be credited with his first year of service for vesting purposes.

If the plan in this **EXAMPLE 9-36** instead uses the elapsed time alternative to determine vesting service, Ron's severance from service date is May 10, 2012. He would have a 60-month period of severance as of May 9, 2017. It is on that date that the five-year break in service is incurred. As Ron does not return until February 10, 2018, the rule of parity would apply and Ron's prior service would be disregarded for vesting purposes. Under the elapsed time method, he would have his first year of service as of February 9, 2019 (i.e., one year following his return).

If You're Curious . . .

Elective Contributions Disregarded Under the Rule of Parity for Pre-2006 Plan Years

For years prior to 2006, elective contributions are disregarded for purposes of applying IRC §411(a) to other contributions or benefits.[50] In other words, to apply the rule of parity to the employer-provided benefits (such as matching contributions or nonelective contributions) the 401(k) plan may treat the employee as zero percent vested, even though he or she is 100 percent vested in the portion of his or her account balance derived from the elective contributions, assuming he or she is otherwise zero percent vested under the applicable vesting schedule. Presumably, contributions that are treated like elective contributions, such as QNECs, may also be disregarded here.

A plan may be written more liberally (i.e., in favor of the employee). Thus, the plan document may provide that, in determining whether the rule of parity applies, an employee who has made elective contributions is not treated as having a zero percent vested interest, even though he or she is zero percent vested under the applicable vesting schedule. This would prevent the break-in-service rule from applying to the employee.

Elective Contributions Included Under Rule of Parity for Post-2005 Plan Years

Regulations modified the rule described above for plan years beginning on or after January 1, 2006, by requiring that elective contributions be taken into account in determining whether the employee is zero percent vested for purposes of the rule of parity.[51] An employer could elect to use these new rules earlier, for plan years ending after December 29, 2004.

Statutory Requirement May Be More Than Five Breaks in Service Under Certain Circumstances

Technically, the minimum five-year break requirement described above is the greater of five breaks in service or the number of years of service credited at the time the break-in-service period begins. The rule applies only to zero percent vested participants. Under all statutory vesting schedules, it is not possible for someone to have more than five years of

[50] Treas. Reg. §1.401(k)-1(c)(1).
[51] *Id.*

service and have no vesting. (Historically, this was not always true.). Therefore, it is correct (and simpler) to think of the rule of parity as applying after a five-year break period.

Five-Year Break-in-Service Rule

The two break-in-service rules discussed above, the one-year break-in-service rule and the rule of parity, affect the crediting of prior service (i.e., service credited before the break-in-service period began) in relation to accounts accumulated after rehire. The **five-year break-in-service** rule affects the crediting of future service (i.e., service credited after the break-in-service period ends) in relation to the vesting of the account that was accrued prior to the break in service period.

Under the five-year break-in-service rule, any future service is taken into account only to determine vesting in benefits accrued after the break-in-service period ends.[52] The vesting percentage applied to any benefits accrued before the break-in-service period is determined at the time of the break and is frozen at that percentage. As a result of the freezing of the vesting percentage, the plan is able to forfeit the nonvested portion of the existing accrued benefit. Because this is essentially a forfeiture rule, the specifics of this break-in-service rule are discussed in more detail in the forfeiture section of this chapter below.

Once a participant earns any degree of vesting (e.g., 20 percent vested under the plan's vesting schedule), there is no break-in-service rule that will permanently disregard his or her prior service for vesting purposes. If the participant incurs a break in service, the only rule that may apply to the prior service is the one-year break-in-service rule discussed above, under which it is possible to get the prior service re-credited.

EXAMPLE 9-37. Effect of a Five-Year Break-in-Service Period. In **EXAMPLE 9-34**, if Andrea's break-in-service period had continued for at least five consecutive breaks in service before she resumed employment, service credited after the break-in-service period would not count toward increasing the vesting of her pre-break accrued benefits. The 80 percent vesting percentage that would apply to Andrea's post-break accruals once she completes an additional year of service would not apply to her pre-break balance. Her pre-break account balance would remain at 60 percent vesting.

MILITARY SERVICE

The Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)[53] was enacted October 13, 1994. USERRA requires special nondiscrimination provisions that apply to a participant who leaves the company to enter military service. Under USERRA, an employer cannot discriminate against any employee or prospective employee with regard to hiring, retention, promotion or any benefit of employment because of military service. IRC §414(u) was added in 1996 to incorporate the USERRA requirements into the IRC.[54]

Vesting Service Credited Following Reemployment

If a service member is reemployed by the employer after an eligible period of military service, that period in the military is treated as if it were continuous service with the employer for purposes of determining all rights, including vesting, under the plan. The reemployed service member is not treated as having a break in service for purposes of applying any of the break-in-service rules and qualified military service must be credited toward the employee's years of service under the plan's vesting schedule.[55]

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[52] IRC §411(a)(6)(C); ERISA §203(b)(3)(C).

[53] 38 U.S.C. §4318.

[54] See, Rev. Proc. 96-49, 1996-2 C.B. 369, for a model amendment that may be adopted to incorporate §414(u) by reference.

[55] IRC §414(u)(8)(A) and (B).

EXAMPLE 9-38. Crediting Period of Military Service for Vesting Purposes After Rehire. Stan was an employee for Corporation X from July 1, 2014, when he was hired, until he left to enter military service on February 15, 2016. At the time that Stan entered the military, he had earned two years of vesting service in Corporation X's calendar year profit sharing plan – for 2014 (in which he earned 1020 hours of service) and 2015 (in which he earned 1850 hours of service). Stan did not complete 1,000 hours of service in 2016 before he left to enter the military in February of 2016. Stan returned to Corporation X immediately upon his discharge from military service on November 1, 2018. Upon his return, under USERRA, Stan was credited with three years of vesting service, for 2016, 2017, and 2018.

Section 9.06: Forfeitures

WHEN ARE FORFEITURES PERMITTED?

A plan may forfeit benefits only under certain circumstances. Forfeiture primarily relates to the loss of a participant's nonvested benefit when certain events occur. Forfeitures usually affect only the nonvested portion of a participant's accrued benefit, although under very limited circumstances, it may affect the vested portion, too.

Forfeiture After Break-in-Service Period or Cash-Out Distribution

The most common situation involving forfeitures is when an employee terminates employment (voluntarily or involuntarily) before reaching 100 percent vesting. The timing of the forfeiture will depend on:

- The terms of the plan;
- When the vested accrued benefit is distributed; and
- Whether the employee returns to employment.

Forfeiture After Five Consecutive Breaks in Service (Five-Year Break-in-Service Rule

If the plan uses the five-year break-in-service rule, a forfeiture of the nonvested benefit occurs at the end of the five-year break-in-service period.[56] Under the five-year break-in-service rule, any service credited after the employee returns from the break-in-service period is taken into account only to determine vesting in benefits accrued after the break-in-service period ends. The vesting percentage applied to any benefits accrued before the five-year break-in-service period is determined at the time of the fifth break in service and is frozen at that percentage. When the vesting percentage becomes frozen, the plan is able to forfeit the nonvested portion of the existing accrued benefit. This forfeiture is not limited to termination of employment. It is possible, although extremely uncommon, for an employee to incur five consecutive breaks in service without terminating employment.

Five consecutive breaks required. For the five-year break-in-service rule to apply, an individual must incur five consecutive breaks in service. An individual incurs five consecutive breaks in service when there are five consecutive one-year vesting computation periods in which the individual is credited with 500 or fewer hours of service in each of those computation periods or, if the plan uses the elapsed time method, when an individual incurs a period of severance that totals 60 months.

EXAMPLE 9-39. Vesting on Return to Service After Five-Year Break. A profit sharing plan defines the vesting computation period to be the plan year. The plan year is the calendar year. The plan uses the six-year graded vesting schedule. Darrin terminates employment on August 15, 2012. Darrin is credited with 900 hours of service during 2012. Darrin's account balance as of December 31, 2012, is

[56] IRC §411(a)(6)(c) and ERISA §203(b)(3)(c).

$20,000 and he has four years of service for vesting purposes. His vesting percentage is 60 percent.

When Darrin returns to employment on June 10, 2018, he will have incurred five consecutive breaks in service because he was credited with no hours of service for the vesting computation periods of 2013, 2014, 2015, 2016 and 2017. Although he will still be at least 60 percent vested in any benefits earned after his return to service and his post-rehire service will increase his vested interest in the benefits he earns after rehire, his vesting percentage in the $20,000 (plus earnings) attributable to his pre-break service will be frozen, and the 40 percent nonvested portion may be forfeited.

EXAMPLE 9-40. Vesting of Pre-Break Blance on Return to Employment. Assume the plan has not distributed Darrin's pre-break account balance, which was valued at $30,000 on December 31, 2017, the last day of the fifth consecutive vesting computation period in which Darrin has a break in service, and the date the five-year break-in-service rule is applicable. At that time, the vesting percentage in Darrin's pre-break account became frozen at 60 percent. Based on his reemployment in 2018, Darrin qualifies for an allocation of profit sharing contributions as of December 31, 2018, in the amount of $5,000.

To properly determine Darrin's vested interest, the plan must make a separate accounting of the pre-break balance (Account Balance A) by establishing a separate account for Darrin's post-break accruals (Account Balance B).

As of December 31, 2017, Account Balance A was reduced from $30,000 to $18,000 due to the forfeiture of the nonvested portion (i.e., 40 percent), because Darrin's vesting percentage in that account is 60 percent. As a result, Darrin is effectively 100 percent vested in Account Balance A going forward, because it represents only the vested portion in his pre-break accrued benefit.

As of December 31, 2018, Darrin has five years of service for vesting in Account Balance B. The five years are determined by crediting Darrin's four prior years credited before the break-in-service period plus his year of service credited for 2018. The five-year break-in-service rule has no effect on determining his service for vesting in Account Balance B. The prior years must be credited for purposes of determining Darrin's vesting percentage in Account Balance B, because he earned an additional year of service for the 2018 vesting computation period (i.e., he has met the condition for the one-year break-in-service rule and is given credit for the prior years of service once he completed the year of service in 2018). The rule of parity would have no effect on Darrin's vesting percentage in Account Balance B because Darrin was not zero percent vested at the time of his break.

When Darrin later becomes 100 percent vested in Account Balance B (i.e., when he is credited with six years of service), the plan may merge Account Balance A with Account Balance B for ease of recordkeeping.

As illustrated in the prior **EXAMPLE 9-40**, the five-year break-in-service rule serves as a forfeiture event for the nonvested portion of the pre-break account balance. That forfeiture is permanent, even if the participant later returns to service.

The five-year break-in-service rule may be used only by: (1) defined contribution plans; and (2) fully insured defined benefit plans. Use of the five-year rule is optional.

Cash-out Contribution Method of Forefiture

The primary drawback to the five-year break-in-service rule is the delay in applying the forfeiture. Pending the fifth break in service, a defined contribution plan must maintain the participant's account balance and credit earnings and losses to the account. However, the plan may accelerate the forfeiture of the nonvested benefit by making a cash-out distribution to the participant.

Requirements for a cash-out distribution. A plan may use a cash-out distribution as a means of forfeiture only if the distribution satisfies the following requirements:[57]

- The entire vested benefit must be distributed. The plan may provide for a partial cash-out distribution, but then only a partial forfeiture is permitted. For example, if the plan cashes out one-half of the vested interest, it may forfeit only one-half of the nonvested interest. A partial cash-out distribution and forfeiture is administratively cumbersome and rarely used, particularly in a defined contribution plan.

If the value of the vested accrued benefit is $1,000 or less, it may be distributed with or without the participant's consent. If the value of the vested accrued benefit exceeds $1,000, a cash-out requires participant consent or it must be effected by rolling over the accrued benefit to an IRA.[58] If the value of the vested accrued benefit exceeds $5,000, the participant must consent to the distribution.

- The cash-out distribution must result in an immediate forfeiture of the corresponding nonvested interest. If the plan postpones the forfeiture until a later time (e.g., the first day of the plan year following the cash-out distribution, or when the five-year break-in-service rule applies), the remaining account balance must be maintained for the employee and the special vesting formula for partial distributions discussed above will apply.[59] (However, until such time as the participant returns to service and earns additional vesting, the account will contain only nonvested funds.)
- The cash-out distribution must be on account of termination of participation in the plan.[60] This means that the employee can no longer be eligible to accrue additional benefits under the plan, either by reason of the employee's termination of employment, or by reason of a change in employment status or the terms of the plan that makes the employee no longer eligible to continue as a participant in the plan. If the employee's participation in the plan is terminating, there must be an event under the plan that permits distribution, or else the vested interest cannot be distributed and the cash-out forfeiture will not apply.
- The plan must comply with certain repayment rules. Under these rules, if a participant returns to covered employment under the plan, he or she must have an opportunity to repay his or her cash-out distribution. If the participant does so, the forfeited amount must be re-credited to his or her account. This process is called "buying back" the forfeiture, and may be done even if the distribution was involuntary. This repayment right applies only if the participant returns to covered employment before incurring five consecutive breaks in service. The plan may limit the participant's repayment period to not less than five years following re-employment.[61]

To have the forfeited benefit restored, the employee generally must repay the amount distributed, without interest. A plan may choose to be more lenient, and to provide for re-crediting the forfeited amount without a repayment of the distribution. The amount restored is the value at the time of the cash-out distribution of the forfeited amount, unadjusted for gains and losses.

EXAMPLE 9-41. Restoration of Account Upon Repayment of Distributed Vested Interest. Mary terminates employment on September 15, 2015. The vesting computation period is the calendar year. Mary is 40 percent vested in her $10,000 account balance. On March 10, 2016, she consents to a cash-out distribution of $4,000. The $6,000 nonvested portion is forfeited. On May 1, 2018, Mary returns. Because she has not incurred five consecutive breaks in service, she has the right to repay the $4,000 distribution. If Mary repays $4,000 to the plan, the $6,000 forfeiture will be restored to her account. Mary must have at least until May 1, 2023 (five years after her return) to make the repayment.

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[57] IRC §411(a)(7)(B) and (C), ERISA §204(d) and (e), and Treas. Reg. §1.411(a)-(d)(4).
[58] IRC §401(a)(31)(B).
[59] Treas. Reg. §1.411(a)-7(d)(5).
[60] See, Treas. Reg. §1.411(a)-7(d)(4)(i)(c) (for involuntary cash-out distributions) and Treas. Reg. §1.411(a)-7(d)(4)(ii)(c) (for voluntary cash-out distributions).
[61] IRC §411(a)(7)(C); ERISA §204(e).

If the participant's forfeiture has already been allocated to other participants, the plan may provide for the following sources of restoration:

1. current unallocated forfeitures;
2. trust gains; or
3. employer contributions.[62]

If the unallocated forfeitures and trust gains are not sufficient, or if the plan does not provide for the use of those sources to restore forfeited benefits, the employer must contribute the amount necessary to satisfy the restoration obligation. In the prior **EXAMPLE 9-41**, suppose Mary repays the distribution during 2018, and there is $15,000 of forfeitures to be allocated under the plan for the 2018 plan year. The plan may use $6,000 of those forfeitures to restore Mary's benefit. If the repayment occurs in the same plan year as the cash-out distribution, the participant's own forfeiture can be used to restore the account balance.

If You're Curious . . .

Repayment rules do not apply if participant is 100 percent vested. The purpose of the repayment rules is to enable a participant to restore a benefit that was previously forfeited because of the cash-out distribution. When a participant is 100 percent vested, a distribution from the account, even if it satisfies the definition of a cash-out distribution, does not result in a forfeiture of any part of the participant's benefit. Therefore, the repayment rules described above are not applicable.

Deemed cash-out for zero percent vested participant. The IRS has routinely approved plan language permitting a plan to deem a terminated participant who is zero percent vested in his or her accrued benefit to be cashed out so that the plan may avoid having to wait until the fifth break in service to forfeit the nonvested amount. If a deemed cash-out provision is used, the plan also must provide for an automatic restoration of the forfeited amount if the employee returns before the five-year break-in-service period. The employee would be deemed to repay the cash-out distribution upon rehire.

The plan must state when the deemed cash-out distribution occurs so it can be determined when the corresponding forfeiture occurs. Many plans state that the deemed cash-out date is the date of termination of employment. However, if under the terms of the plan, the employee would be eligible for an allocation in the year of termination, it may make more administrative sense to provide that the deemed cash-out occurs as of the first day of the next plan year. This way, the employee does not have a deemed cash-out on the date of termination, followed by an allocation that requires another deemed cash-out for which the plan probably does not direct a deemed distribution date.

EXAMPLE 9-42. Deemed Cash-out Rule for Zero Percent Vested Participant. Pam, a participant in a profit sharing plan, terminates employment with only one year of service for vesting purposes. Under the plan's vesting schedule, Pam is zero percent vested in her $2,500 account balance. Under its deemed cash-out rule, the plan treats Pam as if she received a cash-out distribution of $0 as of her termination date, with a corresponding forfeiture of her entire account balance. If Pam returns to employment without having incurred five consecutive breaks in service, the plan deems her to have immediately repaid her cash-out distribution of $0, and the plan restores the forfeited $2,500 account balance. The restored balance will remain zero percent vested until Pam performs enough service to become partially vested.

EXAMPLE 9-43. Deemed Cash-out Occurs on Date of Termination. A plan has a plan year ending December 31. The plan provides for a deemed cash-out rule. Under the plan's provision, the deemed cash-out occurs on the date of termination, except that, in the case of a participant who qualifies for an allocation of employer contributions and forfeitures for the plan year that

[62] Treas. Reg. §1.411(a)-7(d)(6)(iii)(C).

includes his termination, the deemed cash-out occurs as of the first day of the next plan year. On October 1, 2017, Mike terminates employment. Mike is zero percent vested. Under the terms of the plan, employment on the last day of the plan year is required for an allocation of employer contributions and forfeitures. Under the plan's deemed cash-out rule, the deemed cash-out occurs on October 1, 2017, because Mike is not eligible for an allocation for the 2017 plan year.

EXAMPLE 9-44. Deemed Cash-out Postponed to Next Plan Year. Suppose, in the prior **EXAMPLE 9-43**, the plan does not have a requirement of employment on the last day of the plan year to share in allocations. Instead, an employee is entitled to an allocation so long as he or she completes at least 1,000 hours of service. Mike has at least 1,000 hours as of October 1, 2017. Because he will share in allocations for the 2017 plan year, the deemed cash-out under the plan's provision occurs on January 1, 2018.

Optional forms of benefit must be restored when cash-out repayment occurs. When a participant repays a cash-out distribution, the optional forms of benefit available with respect to the accrued benefit being restored must also be restored.[63] In short, once the account is restored, it is as if the distribution never occurred.

Effect of cash-out distribution on years of service for vesting. A cash-out distribution does not affect a participant's service for vesting purposes. The crediting rules and break-in-service rules control the determination of a participant's vesting percentage.

Special vesting formula required if cash-out does not result in immediate forfeiture. If a cash-out distribution is made, but the plan does not provide for forfeiture due to the cash-out, the special vesting formula described earlier in this chapter must be applied to the remaining account balance to determine if the employee has any vesting rights to such account.[64]

USE OF FORFEITURES

The plan document defines how forfeitures are to be used. A defined contribution plan may use forfeitures to reduce the employer's contribution. In this instance, the total amount that the employer needs to fund is reduced by the amount allocated from forfeitures, as discussed below.

Alternatively, a defined contribution plan may use forfeitures to provide additional allocations for participants. In that situation, the employer's contribution amount is not directly affected by the amount of the forfeitures to be allocated, and the forfeitures represent an increase in the amount to be allocated.

If the forfeitures are used to pay expenses, then they are not allocated to the participants' account balances unless the forfeitures exceed the amount needed to pay expenses.

Reducing the Employer's Contribution by the Amount of Forfeitures to Be Allocated

If forfeitures are used to reduce the employer's contribution, it means the forfeitures offset a portion of the contribution the employer is otherwise required to make under the plan. In other words, the amount of the employer's net contribution due equals the contribution amount that normally would be required for the year if there were no forfeitures, minus the amount of the forfeitures. The net contribution plus the forfeitures are then allocated in accordance with the plan's allocation formula.

Because the employer's annual contribution to a profit sharing plan or stock bonus plan is usually discretionary, it

[63] Treas. Reg. §1.411(a)-7(d)(4)(iv)(A).
[64] Treas. Reg. §1.411(a)-7(d)(5).

is more common to see this method of allocating forfeitures used in a money purchase plan or target benefit plan. However, if the profit sharing plan or stock bonus plan calls for a specific contribution amount [e.g., a specified percentage of total participant compensation or a specified percentage of profits, or a fixed matching contribution in a 401(k) plan], the plan might provide for the reduction method in allocating forfeitures. Forfeitures used to reduce contributions in a money purchase plan or target benefit plan reduce the employer's minimum funding obligation for the year.

EXAMPLE 9-45. Money Purchase Plan. A money purchase plan provides for an annual employer contribution in the amount of 10 percent of the participants' combined compensation. The participants' combined compensation for the plan year is $650,000. The employer's required contribution is $65,000. There are $30,000 of forfeitures that are allocable for the plan year. If the plan uses forfeitures to reduce employer contributions, the employer's required contribution is reduced to $35,000. The contribution plus the forfeitures are used to satisfy the $65,000 contribution obligation. As this example illustrates, the allocations to participant account balances will total $65,000 for the plan year, regardless of the amount of forfeitures to be allocated. The allocable forfeitures merely reduce the portion of the $65,000 allocation that must come from new employer contributions.

Forfeitures might not occur until late in the year and some employers contribute all or a portion of their contribution before the end of the plan year. To avoid overcontributing for the plan year, the plan may be designed to have forfeitures used to reduce the employer's contribution in the plan year following the year in which the forfeiture event occurs. If the plan used this approach in the prior **EXAMPLE 9-45**, the employer would make its required contribution of $65,000 for the plan year in which the forfeitures arose, and use the $30,000 forfeiture to reduce the required contribution for the next plan year.

EXAMPLE 9-46. Discretionary Profit Sharing Plan Using Reduction Language. A discretionary profit sharing plan provides that forfeitures reduce employer contributions. Employer contributions are allocated under a pro rata allocation method based on compensation. For the current plan year, there is $11,000 in forfeitures to allocate. The employer's discretionary contribution for the plan year is $77,000. It is assumed the employer has reduced its contribution for the amount of the forfeitures. In other words, the employer would have contributed $88,000 instead of $77,000 if there had not been any forfeiture that year. The contribution plus forfeitures, which total $88,000, are allocated under the plan's allocation method.

Using Forfeitures to Reduce Employer's Matching Contribution Liability

If a plan includes a provision for matching contributions [e.g., elective contributions under a 401(k) arrangement are matched by the employer], forfeitures may be used to reduce the employer's matching contribution obligation. Sometimes only forfeitures attributable to matching contributions are used to reduce the matching contributions the employer would otherwise have to make, with other forfeitures (i.e., forfeitures attributable to nonelective contributions) allocated as additional nonelective contributions. Forfeitures of matching contributions do not have to be used to reduce the employer's matching contribution liability. The plan may use forfeitures of matching contributions to increase the allocations for other participants, either as increased matching contributions or as increased nonelective contributions, or to pay plan expenses.

EXAMPLE 9-47. Use of Forfeiture to Reduce Matching Contributions. Meryl is a participant in a profit sharing plan that includes a 401(k) arrangement. The plan provides for matching contributions and discretionary employer nonelective contributions. Matching contributions and nonelective contributions are subject to a vesting schedule. Meryl incurs a forfeiture of her nonvested interest when she receives a cash-out distribution from the plan following her termination of employment. Her

forfeiture includes $1,600 from her matching contribution account and $3,100 from her employer nonelective contribution account, for a total forfeiture of $4,700.

The plan provides that all forfeitures are used to reduce employer matching contributions, regardless of whether the forfeitures are attributable to matching contributions or to nonelective contributions. The forfeitures are used to satisfy $4,700 of matching contributions the employer is required to make for other participants. Thus, if the matching contributions that the employer would have to make for the plan year total $50,000 and Meryl's forfeitures were the only forfeitures for that year, the employer would contribute only $45,300, and use Meryl's forfeiture of $4,700 to pay for the difference. The participants who are eligible for matching contributions in that plan year do not get any lesser amount of match because of the reduced employer contributions; Meryl's forfeiture is paying for part of that match.

EXAMPLE 9-48. Forfeitures Used to Reduce Contributions Based on Source of Forfeiture. Suppose in the prior **EXAMPLE 9-47** that forfeitures attributable to nonelective contributions are allocated as additional nonelective contributions for the plan year. In this case, only $1,600 of Meryl's forfeiture, which is attributable to her matching contribution account, is used to reduce the employer's matching contribution deposits for the plan year. The other $3,100 is added to the employer nonelective contribution for the plan year and allocated accordingly.

If You're Curious…

Prefunding Prohibition Under Treasury Regulations Will Not Interfere With This Approach

Treasury Regulations under IRC §401(k) generally prohibit the prefunding of matching contributions (i.e., employer cannot contribute the match before the elective contribution to which it relates is actually made or before the employee's performance of service with respect to such elective contributions).[65] However, this prohibition does not apply to a forfeiture that is allocated as a matching contribution.[66]

Forfeitures Used to Reduce Elective Contributions

Treasury Regulations also prohibit the contribution of elective contributions made on behalf of an employee before the employee performs the services to which the elective contributions relate (or before the compensation would have otherwise become currently available had the deferral election not been made).[67] While an exception is made for forfeitures applied to matching contributions, no exception is made for forfeitures that are allocated to satisfy the employer's contribution obligation with respect to elective contributions. Thus, the allocation of a forfeiture to another employee's account to satisfy the employer's obligation to contribute the employee's elective contributions would be in violation of the regulations.

Forfeitures Used to Reduce Qualified Nonelective Contributions, Qualified Matching Contributions and 401(k) Safe Harbor Contributions

QNECs, QMACs and safe harbor contributions are required to be fully vested upon contribution.[68] As a result, the IRS at one time took the position that forfeitures (which, by definition, were at one time not vested) may not be used to reduce the employer's contribution of these types of amounts.

[65] Treas. Reg. §1.401(m)-1(a)(2)(iii)(A).
[66] Treas. Reg. §1.401(m)-1(a)(2)(iii)(B).
[67] Treas. Reg. §1.401(k)-1(a)(3)(iii)(c).
[68] IRC §§401(k)(3)(D)(ii) and 401(k)(12)(E).

However effective in 2017, the IRS changed its position and allows the forfeitures to be used to reduce Qualified contributions if the document states such.[69]

Using Forfeitures to Provide Additional Allocations to Participants

Under this approach, the forfeitures are treated as additional employer contributions for purposes of the allocation formula. If a profit sharing plan or a stock bonus plan includes a discretionary nonelective contribution formula, the plan typically provides for this approach to allocate forfeitures. The participants receive a greater allocation than they otherwise would have received had the employer's discretionary nonelective contribution been the only amount to be allocated for the plan year. Of course, the employer could, in its discretion, make a lesser contribution because it is aware of the forfeitures to be allocated and does not wish the participants to receive an allocation windfall.

This approach (i.e., using forfeitures to provide additional allocations to participants) may also be used where the employer's contribution is not discretionary, even in a pension plan, such as a money purchase plan. If this approach is used with a nondiscretionary employer contribution, the employer's contribution obligation is unaffected by the forfeitures, and the participants realize greater allocation levels than they would if no forfeitures were allocated for that year.

If the plan provides for permitted disparity, the disparity can be applied only once. Therefore, either the forfeitures are added to the employer contribution and then the total is allocated using the permitted disparity formula or the contribution is allocated using permitted disparity and then forfeitures are allocated on a pro rata basis.

EXAMPLE 9-49. Discretionary Profit Sharing Plan. A profit sharing plan has a discretionary contribution formula and allocates forfeitures in the same manner as nonelective contributions. The employer contributes $50,000 for the plan year. There is also $30,000 in forfeitures. The total amount of $80,000 is allocated under the plan. The participants receive a greater allocation for the year than they would if only the employer's contribution of $50,000 were allocated. Of course, as the employer's contribution is discretionary, the employer may reduce the amount it decides to contribute because of the amount of forfeitures to be allocated for the plan year.

EXAMPLE 9-50. Money Purchase Plan. A money purchase plan's contribution formula requires a contribution in an amount equal to 10 percent of the combined compensation of all eligible participants, to be allocated pro rata to compensation. The plan further provides that forfeitures are allocated in the same manner as contributions. The combined compensation of all eligible participants for the current plan year is $400,000. The required employer contribution is $40,000. There is $25,000 of forfeitures to be allocated for the same year. The plan allocates the forfeitures in addition to the required employer contribution. The total amount of contributions and forfeitures to be allocated for the year is $65,000, resulting in a 16.25 percent allocation to each participant (i.e., $65,000 is 16.25 percent of the combined compensation of $400,000). Had there not been any forfeitures, each participant's allocation rate would have been only 10 percent of compensation. If the plan had used forfeitures to reduce employer contributions, each participant's allocation rate also would have been only 10 percent of compensation, because the employer would have reduced its contribution to $15,000 which, together with the $25,000 of forfeitures, would have satisfied the required contribution of $40,000.

Using Forfeitures to Increase Rate of Matching Contributions

Forfeitures can also be used to increase the rate of matching contributions under a plan. If the profit sharing plan described in **EXAMPLE 9-49** above includes a 401(k) arrangement, it might provide that the $30,000 of forfeitures are first applied

[69] See IRS Q&A Session Q&A-21, 2011 ASPPA Annual Conference in National Harbor, MD.

to increase the rate of match for the plan year. With such an approach, a participant in a plan that normally provides a 50 percent rate of match might in fact receive a 55 percent rate of match because of the allocation of forfeitures.

Some plans provide for a separate allocation of forfeitures that are attributable to matching contributions. Under such approach, matching forfeitures are allocated to increase the rate of match or to reduce the employer's matching contribution obligation, and forfeitures of the employer's nonelective contributions are allocated as part of the employer's nonelective contributions for the plan year. As noted above, the Treasury Regulations that prohibit prefunding of matching contributions do not preclude the allocation of forfeitures as matching contributions.[70]

Payment of Plan Expenses with Forfeitures

A plan may provide for the use of forfeitures first to pay reasonable administrative expenses.[71] To the extent forfeitures exceed the amount required to pay expenses, the plan should specify whether the excess should be applied to reduce employer contributions or added to participants' accounts as additional allocations.

Forfeiture Suspense Accounts

Forfeitures may not be held in a suspense account, unless there is a permissible reason for the establishment of such suspense account. The IRS takes the position that the funds under a defined contribution plan generally must be allocated to participants' accounts at least annually.[72] A suspense account may be maintained only where specifically permitted by statute, regulations or rulings. For example, a suspense account may be maintained in an ESOP to hold employer securities that have been acquired with an exempt loan that has not been fully repaid.

Forfeitures should be held in a suspense account only under the following circumstances.

- The plan uses forfeitures to reduce employer contributions, and the forfeitures exceed the amount required to be contributed for the year. In this case, the excess forfeitures are held in suspense and allocated to reduce employer contributions in the next year and subsequent years, if necessary. The employer would not make additional contributions until the forfeitures are fully absorbed.
- The plan designates that a given year's forfeiture is allocated in the following year. In this case, forfeitures that arise for the plan year are held in suspense at least until the next year, because the plan does not allocate the forfeitures until that next year. Plans sometimes take this approach because the amount of the forfeitures incurred for a plan year might not be known until after employer contributions for the plan year have already been funded. If the forfeitures are used to reduce employer contributions, and the forfeitures exceed the required contribution for the next plan year, the excess forfeitures may be held in a suspense account and used to reduce the required contribution for succeeding years until they are fully absorbed.
- The plan's allocation date has not occurred. In this case, the plan allocates forfeitures only once per year, and forfeitures arise before the applicable allocation date. For example, the plan might cash out a participant in February, resulting in a forfeiture of the nonvested interest at that time, but the forfeiture is allocated as of a December 31 allocation date. Until the allocation date, the forfeiture may be held in a suspense account.

If You're Curious…

Forfeitures That Exceed Plan Expenses

If the plan uses forfeitures to pay for expenses, would it be possible to hold the excess forfeitures in a suspense account, and use that suspense account to pay expenses in future years? Probably not. The

[70] Treas. Reg. §1.401(m)-1(a)(2)(iii)(B).

[71] Rev. Rul. 84-156, 1984-2 C.B. 97.

[72] Rev. Rul. 80-155, 1980-1 C.B. 84.

language in the applicable IRS guidance suggests that any forfeitures remaining after expenses are paid must be applied to provide benefits to the other participants, either in payment of a portion of the employer's contribution or as an additional employer contribution.[73] This is consistent with the general principle that all amounts must be allocated under a defined contribution plan.

Modifying the Plan's Method of Allocating Forfeitures

The plan's method of allocating forfeitures may be changed. Any feature in a plan may be changed, provided that the amendment does not cause the reduction of a benefit that has already been accrued (known as the anti-cutback rule) and the amendment does not otherwise conflict with a statutory or regulatory requirement [e.g., the qualification requirements under IRC §401(a) or the requirements under Title I of ERISA]. If the amendment is effective prospectively to the beginning of the next plan year, there should not be any anti-cutback violation, because the amendment changing the method of allocating forfeitures will apply only to future allocations of forfeitures. However, if the amendment is effective for the plan year in which the amendment is adopted, the possibility that some participants may have already accrued a right to the allocation of forfeitures for that plan year must be taken into consideration.

Section 9.07: Review of Key Concepts

- What is vesting?
- What are the statutory minimum schedules for vesting purposes?
- How do the statutory minimum schedules differ for employer nonelective and employer matching contributions, post-PPA?
- Identify scenarios in which full vesting is required in a plan.
- Apply a participant's vesting percentage to his or her accrued benefit to determine the vested benefit.
- Define a year of service for vesting purposes.
- What are the two methods available for determining a year of service for vesting purposes?
- Define a vesting computation period and name two ways the vesting computation period may be determined.
- Identify the types of service that must be included in determining a participant's vesting service and the types of service that may be excluded.
- Define break in service.
- When must a participant on leave be credited service to avoid a break in service for vesting purposes?
- Identify the three break-in-service rules applicable to vesting and determine when each may be applicable.
- Define forfeiture.
- When do forfeitures occur?
- How may forfeitures be used in a plan?

Section 9.08: For Practice – True or False

1. Under the six-year graded vesting schedule, the vested percentage for a participant who has completed three years of service is 40 percent.
2. A plan may disregard all years of service prior to plan entry for determining vesting.
3. A plan must provide for full vesting upon the total disability of a participant.

[73] Rev. Rul. 84-156, 1984-2 C.B. 97.

4. A 401(k) plan with a discretionary match may use a five-year cliff vesting schedule to determine a participant's vested balance in the matching account.
5. A one-year break in service is a vesting year with 500 or fewer hours.
6. A plan may define a break in service as 250 or fewer hours of service.
7. If a participant is partially vested or 100 percent vested, years before a break in service may be excluded in crediting service for vesting in the account accumulated after the participant's rehire.
8. Forfeiture is deemed to occur on the date the participant terminates employment.
9. Hours of service are not counted when using the elapsed time method for measuring vesting service.
10. A participant on unpaid paternity leave must be credited with enough hours to avoid a break in service for vesting purposes.

Section 9.09: Sample Test Questions

1. Based on the following information, determine Participant A's vested account balance on December 31, 2018:
   - The plan uses a six-year graded vesting schedule, taking into account all years of service for vesting purposes.
   - Participant A works a full-time schedule when employed.
   - Participant A terminated her employment with the plan sponsor, but did not receive a distribution of her account balance from the plan.
   - Participant A is later rehired.

Date of Hire	January 1, 2012
Date of Termination	December 31, 2015
Date of Rehire	December 31, 2017
Account Balance (12/31/2018)	$10,000

   A. $0
   B. $2,000
   C. $4,000
   D. $6,000
   E. $8,000

2. All of the following statement regarding years of service for vesting purposes are TRUE, EXCEPT:
   A. Periods prior to age 21 may be disregarded.
   B. Periods prior to the effective date of the plan may be disregarded.
   C. Periods prior to plan entry must be counted unless a different exception applies.
   D. Periods during which the participant had certain breaks in service may be disregarded.
   E. Periods while suspended from plan participation due to employment classification must be counted unless a different exception applies.

3. All of the following events require full vesting, EXCEPT:
   A. A participant attains NRA.
   B. A participant is credited with seven years of service.
   C. A participant attains early retirement age.
   D. A plan requires 18 months of service for eligibility purposes.
   E. A participant is affected by a plan termination.

4. Which of the following is/are vesting schedules that satisfy minimum vesting standards for defined contribution plans, post-PPA?

    I. Two-year cliff (0% until year 2, then 100%)
    II. Three-year graded (0% until year 2, then 50% each year thereafter)
    III. Five-year graded (0% until year 2, then 25% each year thereafter)

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

5. All of the following statements regarding a break in service for vesting purposes are TRUE, EXCEPT:

    A. Generally, a break in service occurs in a vesting computation period during which the participant is credited with 500 or fewer hours of service.
    B. A participant who completed 400 hours of service before an unpaid maternity leave may not incur a break in service if she would have had more than 500 hours of service without the leave.
    C. A participant must terminate employment to incur a break in service.
    D. It is permissible for a plan to define a break in service as fewer than 500 hours of service..
    E. A participant re-employed after an eligible period of military service does not incur a break in service.

6. Which of the following statements regarding forfeitures in a defined contribution plan is/are TRUE?

    I. Forfeitures cannot be reallocated to other participants until a one-year break in service has occurred.
    II. Matching forfeitures may be allocated as employer contributions other than matching contributions.
    III. The amount of forfeitures is deductible as an employer contribution each plan year.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

7. Based on the following information, determine the participant's vested balance:

Years of vesting service:	4
Plan vesting schedule:	6-year graded
Rollover account balance:	$100,000
401(k) account balance:	$50,000
Profit sharing account balance:	$30,000
Safe harbor matching account balance:	$25,000

    A. $123,000
    B. $172,000

C. $181,000
D. $193,000
E. $205,000

8. Based on the following information, determine Participant C's vested percent as of June 30, 2018:
    - The plan year is July 1 to June 30.
    - The plan has been in effect since July 1, 2001.
    - Participant C was hired April 15, 2013, and has always worked full time.
    - Participant C has not reached NRA.
    - The plan specifies a six-year graded vesting schedule.
    - The plan is not top-heavy.
    - All years of service are included for vesting purposes.
    - Vesting service is based on the plan year.

    A. 20%
    B. 40%
    C. 60%
    D. 80%
    E. 100%

9. Which of the following is/are events that require full vesting of a participant's benefit?
    I. Death of the participant
    II. Attainment of NRA under the plan
    III. Becoming disabled, according to the plan's definition

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

10. Based on the following information, determine the amount forfeited by Participant X:
    - Participant X terminated employment three years ago.
    - Participant X was 60% vested.
    - Participant X took a distribution of his entire vested account in the current plan year.
    - Participant X's account balance subject to vesting at the time of distribution was $42,000.

    A. $16,800
    B. $25,200
    C. $33,600
    D. $40,000
    E. $42,000

See next page for answers to the true/false and sample test questions.

Section 9.10: Solutions to True or False Questions

1. True.
2. False. A plan may disregard all years of service prior to the effective date of the plan when determining vesting. To satisfy the minimum vesting requirements of IRC §411, a participant's vested percentage must be based on years of service and may not credit vesting only from a participant's entry date.
3. False. A plan is not required to provide for full vesting upon the total disability of a participant, although many plans do.
4. False. The plan must use either a six-year graded or three-year cliff schedule or any more liberal vesting schedule.
5. True.
6. True.
7. False. If the plan document includes break-in-service rules, the pre-break service of nonvested participants may be disregarded. The pre-break service of partially vested participants must be counted.
8. False. The plan document dictates when forfeiture is deemed to occur. Many plans provide that forfeiture occurs as of the earliest of five consecutive one-year breaks in service or a complete distribution of the participant's account balance.
9. True.
10. True.

Section 9.11: Solutions to Sample Test Questions

1. The answer is **E**. Participant A had four years of service prior to her termination (2012, 2013, 2014 and 2015). In determining her vested benefit, years before a break in service may be disregarded only if she has five consecutive one-year breaks in service and was not vested at date of termination. Because Participant A only had two consecutive one-year breaks in service (2016 and 2017), and was partially vested, her pre-break service may not be disregarded. Therefore, Participant A has a total of five years of service for vesting purposes (four pre-break and one post-break). Under the six-year graded vesting schedule, Participant A is 80 percent vested. Her vested account balance is $8,000 ($10,000 x 80%).
2. The answer is **A**. A plan may exclude years of service prior to age 18, not 21.
3. The answer is **C**. Although a plan may provide that a participant is fully vested upon reaching early retirement age, full vesting is not required.
4. The answer is **E**. All of the vesting schedules shown satisfy minimum vesting standards for defined contribution plans post-PPA. Customized cliff or graded vesting schedules are permissible, provided that defined contribution plan participants are no less vested at any point in time than they would be under the statutory cliff or graded vesting schedules (i.e., for a cliff vesting schedule, participants must be 100 percent vested on or prior to completion of three years of service and for a graded vesting schedule, participants must be at least 20 percent vested upon completion of two years of service, at least 40 percent vested upon completion of three years of service, and so on).
5. The answer is **C**. A participant does not need to terminate employment to incur a break in service. Failure to complete more than 500 hours of service (or fewer hours if the plan defines a break in service using a lesser number of hours) in a plan year will result in a break in service, even if the participant is still employed.
6. The answer is **B**. Forfeitures may be reallocated to other participants before a one-year break in service has occurred. Forfeiture amounts are not deductible. The employer already received a deduction for these amounts when they were originally contributed to the plan.

7. The answer is **D**. The six-year graded vesting schedule provides 60 percent vesting after four years of vesting service. The vested percentage applies only to the profit sharing account balance ($30,000 x 60% = $18,000). The other contribution types (i.e., rollover contributions, elective contributions and safe harbor matching) are all 100% vested. Thus, the participant's vested balance is $193,000 ($100,000 + $50,000 + $18,000 + $25,000).
8. The answer is **D**. The six-year graded vesting schedule provides 20 percent vesting after two years of vesting service, and then an additional 20 percent per year until full vesting is attained after six years of vesting service. Participant C worked full time since being hired in April of 2013 and vesting is based on the plan year, therefore, Participant C would have worked 1,000 hours in plan years ended 06/30/2014, 06/30/2015, 06/30/2016, 06/30/2017 and 06/30/2018. With five vesting years, Participant C would be 80 percent vested.
9. The answer is **B**. Although a plan may provide that a participant is fully vested upon death or disability, full vesting is not required.
10. The answer is **A**. Participant X was 60 percent vested upon termination. Participant X received a distribution of $25,200 ($42,000 x 60%). The remaining 40% or $16,800 ($42,000 x 40%) was forfeited.

Chapter 10:
Plan Amendments and Terminations

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Section 10.01: Key Terms

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- Ancillary benefit
- Anti-cutback rule
- Applicable individual
- Egregious failure
- ERISA §204(h) amendment
- ERISA §204(h) notice
- Frozen plan
- IRC §411(d)(6) protected benefits
- Noncompliance period
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Section 10.02: Introduction

One of the most important concerns for qualified plans relates to the amendment and termination of the plan. First, when a plan is amended, its operations are being changed to match the intent of the plan sponsor. It is critical to prepare an amendment as intended. The ramifications of an incorrectly documented amendment can be far-reaching, including contribution obligations that may not have been intended, allocations due to the wrong accounts or in the wrong amounts, benefit accruals that exceed expectations or possibly the failure to earn benefits even though the parties wanted those additional benefits to accrue.

Second, the amendment of a plan invokes concerns regarding the rights of participants. Often, the plan prior to amendment would create benefits or allocations for participants that will no longer be available after the amendment is completed. It is important to understand how the law protects rights and benefits that have already been earned, and what must occur before such earned status applies. IRC §411(d)(6) governs this part of the law, and this IRC section and the attendant regulations are not always easy to understand.

When a plan was amended prior to 2017, the new documentation could have been submitted to the IRS for a favorable determination letter. This process was discontinued by the IRS in 2017 so special care needs to be taken in drafting and implementing any amendments. On occasion, the amendment contains language that would cause the plan to be disqualified. In some situations, the law changes and plan documents must be updated to conform. The IRS will provide a remedial amendment period during which the plan must be amended to conform to the change. If the amendment is not made within the remedial amendment period, the plan is subject to disqualification because of the needed modification.

Plan termination is the act of permanently ceasing the operations of the plan. The termination of a plan requires that certain procedures be followed, including paying all benefits in the plan to the participants and preparing and filing all final reporting.

This chapter discusses the amendment and termination procedures, including the remedial amendment period, as well as the special rules regarding protection of benefits on amendment and partial plan terminations.

Section 10.03: Plan Amendments

A qualified plan may be amended by the plan sponsor, assuming that the plan document so permits (and most plan documents do so permit). However, certain rules regarding the protection of benefits earned to date and ensuring that benefits are not discriminatory, place limitations on the right of the plan sponsor to amend the plan. Furthermore, the timing of the amendment may be important to maintaining plan qualification. This section will discuss these issues.

AMENDMENT PROCEDURES

Every employee benefit plan subject to ERISA must be established and maintained pursuant to a written instrument.[1] The documents under which a plan operates establish the terms of the plan and the rights of the plan participants and beneficiaries. They also set the parameters of the fiduciaries' duties and responsibilities. A fiduciary is required to follow the governing documents unless those documents are contrary to ERISA.

Similarly, plan amendments must be in writing. ERISA requires that the plan provide a procedure for amending the plan.[2] ERISA requires two things: (1) a procedure for amending the plan; and (2) a procedure for identifying the persons who have authority to amend the plan. A reference in the plan to "the Company" satisfies the requirement to identify the persons with authority to amend the plan. The plan is not required to include additional language for identifying the person(s) with authority to act on behalf of the corporation (such as the Board of Directors), as that is a matter of state corporate (or other entity) law.[3]

It is clear from the language of the law regarding written plans and a provision permitting the company to amend a plan that the company may act unilaterally to amend the plan and only the company has that authority. No third party (such as the trustee or the union) is required to participate in or approve the amendment unless some other documentation imposes that requirement.

Amendment Form

In some cases, a corporation's Board of Directors has taken action to amend the plan by resolution, without the formal execution of a written amendment to the plan. This may or may not prove to be a valid amendment of the plan. Needless to say, the safest route to having a bona fide amendment is to have a separate written amendment document that is authorized by the governing body of the plan sponsor.

Effect of Improper Amendment

If the amendment is not properly made, or if the amendment is made by a person or entity that has no authority to amend the plan, it is likely that the amendment is void.

NONDISCRIMINATORY AMENDMENTS

The timing of a plan amendment, or a series of plan amendments, may not discriminate significantly in favor of HCEs.[4] The discriminatory effect of a plan amendment is determined under the relevant facts and circumstances. Such facts and circumstances include the relative numbers of current and former HCEs and NHCEs affected by the amendment, the relative length of service of current and former HCEs and NHCEs, the length of time the plan has been in effect and the turnover of employees prior to the amendment.

Establishment or Termination of Plan Treated as Amendment

A plan amendment includes the establishment of the plan and the termination of the plan. For example, if a new defined benefit plan is established, but credits past service with the employer to determine benefits, the granting of that past service is treated as a plan amendment that must not discriminate significantly in favor of HCEs.

EXAMPLE 10-1. Past Service Favors HCEs. A corporation establishes a new defined benefit plan in 2018. The plan covers two HCEs and four NHCEs. The corporation has been in existence since 2008.

[1] ERISA §402(a)(1).
[2] ERISA §402(b)(3).
[3] *Curtiss-Wright v. Schoonejongen*, 115 S.Ct. 1223 (1995).
[4] Treas. Reg. §1.401(a)(4)-5(a).

During that time, there has been significantly greater turnover of NHCEs, so that the ratio of current HCEs to former HCEs is substantially higher than current NHCEs to former NHCEs. The plan credits past service (i.e., service before the plan's effective date) in determining benefits. Each HCE has ten years of past service. The past service for the NHCEs ranges from one year to seven years. The timing of the establishment of the plan, coupled with the granting of past service credit, may be considered to have the effect of significantly discriminating in favor of HCEs.

Safe Harbor for Past Service Credits Limited to Five Years

If a plan amendment credits years of service for past periods to determine benefits, the amendment is deemed to be nondiscriminatory if no more than five years of past service is credited, the past service is granted on a reasonably uniform basis, and the service can be taken into account under the service crediting rules of Treas. Reg. §1.401(a)(4)-11(d)(3).

Effect of Determination Letter

If the employer had obtained a favorable determination letter on a plan amendment (or on the plan, as amended), the determination letter may be relied on with respect to whether the timing of the plan amendment satisfies this nondiscrimination requirement. A conversion of a plan into another type of plan (e.g., conversion of a money purchase plan into a profit sharing plan) is an amendment, so the rules discussed in this section are applicable. Also note that the conversion of a defined benefit plan into a defined contribution plan, or vice versa, is really not possible because of the protected optional form of benefit rules under IRC §411(d)(6) (see below). Any amendment purported to create such a conversion really results in a plan that has both defined benefit and defined contribution features.

AMENDMENT MAY NOT REDUCE ACCRUED BENEFITS

A plan cannot be amended to reduce accrued benefits.[5] However, an amendment may reduce the rate at which participants will earn benefits in the future. The prohibition against reducing accrued benefits is known as the **anti-cutback rule** and is found in IRC §411(d)(6). The anti-cutback rule is easy to conceptualize when an amendment attempts to reduce a participant's account balance or a participant's accrued benefit under a defined benefit plan. It is more subtle when an amendment is made during a plan year that affects the allocation of employer contributions for that plan year under a defined contribution plan, or which affects the amount of benefit accrued for that plan year under a defined benefit plan.

The anti-cutback rule prohibits the reduction of any benefit that has already accrued for that plan year under the pre-amendment formula, even if the contributions necessary to fund those accrued benefits have not been made by the employer. The plan's requirements for receiving a defined contribution plan allocation or accruing a benefit under a defined benefit plan will affect whether the timing of the amendment violates the anti-cutback rule.

Protecting Optional Forms of Benefit and Early Retirement Subsidies

A plan amendment that has the effect of eliminating an optional form of benefit or eliminating or reducing an early retirement benefit or retirement-type subsidy is treated as an amendment that reduces a participant's accrued benefit in violation of IRC §411(d)(6) if the amendment applies to accrued benefits (i.e., benefits accrued as of the amendment date, which is the later of the adoption date or effective date of the amendment).[6] Benefits that are protected are called – appropriately enough – **IRC §411(d)(6) protected benefits**.

A series of plan amendments made at different times that, when taken together, constitute the elimination or reduction of a valuable right, is treated as an impermissible elimination or reduction under IRC §411(d)(6).[7]

[5] IRC §411(d)(6); ERISA §204(g).
[6] IRC §411(d)(6)(B).
[7] Treas. Reg. §1.411(d)-4, Q&A-1(c).

Definition of Optional Form of Benefit

An **optional form of benefit** is any option that relates to the form or timing of distribution under the plan.[8] Options to take a distribution in the form of a lump sum, annuity or installments are optional forms of benefit. An ability to request distribution in the plan year following separation from service relates to the timing of payment and is an optional form of benefit. Also, the right to elect an in-service withdrawal (e.g., upon attaining a certain age) is a protected optional form of benefit.

A method of paying benefits (i.e., form, timing or medium of payment) is an optional form of benefit, even if the participant does not have the right to elect another option. In other words, a form of payment that is mandatory under the plan (e.g., an involuntary cash-out distribution in a single-sum) or the normal form of benefit under a defined benefit plan (e.g., a QJSA as the normal form of benefit) is still an optional form of benefit, even if the participant does not have the right to choose a different form of payment.

Examples of Optional Forms of Benefit

Some common examples of optional forms of benefit include:

- Forms of payment:
  1. single-sum distribution option;
  2. life annuity distribution option;
  3. joint and survivor annuity option; and
  4. term-certain installment option.
- Timing of payment following severance of employment:
  1. distribution immediately upon severance from employment;
  2. distribution in the first plan year that begins after severance of employment;
  3. distribution delayed until NRA is attained;
  4. distribution upon reaching the required beginning date under IRC §401(a)(9);
  5. distribution in any plan year following severance of employment for which the participant makes an election to receive distribution.

In any of these examples, the plan might provide for distribution as soon as administratively feasible after the event or election occurs. If the distribution is not mandatory, the participant would also have the right not to elect distribution at that time and postpone distribution to a later time.

- Timing of payments while in service (i.e., in-service withdrawal options):
  1. hardship withdrawals;
  2. distribution after reaching a certain age (e.g., age 59½, NRA);
  3. distribution available from employer contributions that have accumulated for at least two years (available only under profit sharing plans or stock bonus plans);
  4. distribution available after minimum period of participation (e.g., five years) (available only under profit sharing plans or stock bonus plans).
- Medium of payment:
  1. cash (most common);
  2. employer securities;
  3. in-kind investments (other than employer securities) held in the participant's account;
  4. annuity contract.

IRC §411(d)(6) Protected Benefits That May Be Eliminated

The general rule of IRC §411(d)(6) is that neither accrued benefits nor benefit forms may be altered by amendment in

[8] Treas. Reg. §1.401(a)(4)-4(e)(1).

relation to benefits already earned. However, there are many exceptions to this general rule.

The IRC authorizes the Treasury to issue regulations that permit the elimination of an optional form of benefit.[9] The Treasury and the IRS have exercised this authority on several occasions. For example, the following changes are permitted:

- A change in the definition of the required beginning date for required minimum distributions (RMDs) after age 70½ to reflect legislative changes to IRC §401(a)(9);
- The right to retroactively adopt conforming amendments that restrict distribution rights to 401(k) safe harbor contributions;
- The right to eliminate hardship withdrawals; and
- The right to modify certain options in stock bonus plans.

Elimination of a Form of Distribution from a Defined Contribution Plan

A form of distribution (i.e., payment method options) under a defined contribution plan may be eliminated, without protecting that option with respect to a participant's accrued benefit, so long as a lump-sum option is available to the participant at the same time or times as the form of distribution being eliminated, and the single-sum payment option is based on an equal or greater portion of the participant's account as the form of distribution being eliminated.[10]

EXAMPLE 10-2. Elimination of Installment Payments. Corporation Q sponsors a profit sharing plan that permits distributions of accounts in excess of $5,000 only at NRA (age 65) and only in the form of installment payments over a period of 10 years or more. On July 1, 2018, Corporation Q amends the plan to permit distributions at any time after termination of employment, to eliminate the installment payment option and to permit only lump-sum distributions. The amendment does not violate the anti-cutback rules, because participants do not have to wait any longer to be eligible to receive their benefit and a lump sum is available as an alternate to the eliminated form of distribution.

EXAMPLE 10-3. Profit Sharing Plan with Several Installment Options. A profit sharing plan offers installment payment options for any specified term of years not exceeding 20, as well as a single-sum distribution option. The plan does not provide for annuity distribution options, so the QJSA rules are not applicable to the plan. The plan is amended to eliminate the installment distribution option, leaving only the single-sum payment option under the plan, even with respect to benefits accrued as of the amendment date. The amendment does not violate the anti-cutback rule.

An amendment may not take away the right to receive a benefit that is currently available and instead make it available at a later date. In other words, a participant's right to take a distribution at a given time may not be cut back.

EXAMPLE 10-4. Amendment to Change the Timing of Distributions Following Termination of Employment. A 401(k) plan provides that, upon termination of employment, a participant may take a distribution as soon as administratively feasible. A significant number of terminated employees are electing immediate distribution. The employer is concerned that employees are looking at the plan benefit as a severance benefit and would like to delay access to benefits following termination of employment. An amendment is adopted, effective January 1, 2018, to delay the earliest available distribution until the second plan year following severance from employment.

The right to take distribution immediately upon severance from employment is a protected benefit

[9] IRC §411(d)(6)(B).

[10] IRC §411(d)(6)(E), Treas. Reg. §1.411(d)-4, Q&A-2(e).

option and it would be a prohibited cutback if it applied to benefits accrued before January 1, 2018. Five years later, Sergio terminates employment. Sergio has a right to receive distribution from the protected portion of his account balance (i.e., the portion that accrued prior to January 1, 2018) as soon as administratively possible after his termination of employment.

Elimination of QJSA and annuity provisions. Annuity options may be eliminated anytime from a profit sharing plan or stock bonus plan without violating the anti-cutback rules. If all annuity options are eliminated and all other requirements are met, the obligation of the plan to provide a qualified joint and survivor annuity (QJSA) or qualified preretirement survivor annuity (QPSA) is also eliminated.

However, the regulations do not override the statutory requirements regarding the QJSA rules. As a result, the QJSA rights cannot be eliminated from a pension plan. Furthermore, if a nonpension plan is the direct transferee of a money purchase plan (or the surviving plan in a merger with a money purchase plan),[11] the QJSA option cannot be eliminated, at least with respect to the transferred benefits. It is possible for a plan to maintain different distribution options and rights for different types of plan accounts such as, a lump sum only (and no spousal consent rules) for the profit sharing account, but QJSA rights and annuity options for the money purchase transferred accounts must remain in effect.

EXAMPLE 10-5. Elimination of QJSA in a Profit Sharing Plan. Corporation R's profit sharing plan provides for annuity payment options, so it is subject to the QJSA requirements under IRC §§401(a)(11) and 417. The plan has received no transfers from a pension plan that must be subject to QJSA requirements. Corporation R amends its plan on November 10, 2017, to eliminate the annuity payment options. After the amendment, all participants are eligible for just two forms of payment: (1) a single-sum distribution; or (2) installment payments over a period not exceeding the participant's life expectancy or the joint life expectancy of the participant and the participant's spouse. The QJSA option is not available after the amendment, even on benefits accrued as of the date of the amendment. The amendment does not violate the anti-cutback rules.

In the above **EXAMPLE 10-5**, IRC §411(d)(6) would not be violated even if the amendment eliminated the installment distribution options as well, leaving only a single-sum distribution option after the amendment is effective.

On the other hand, according to the IRS, the right to elect a distribution without spousal consent is not protected under IRC §411(d)(6).[12] For example, an employer that merges a money purchase plan into a profit sharing plan might decide to amend the profit sharing plan to add QJSA provisions to match the required distribution provisions of the transferred balances from the money purchase plan, which must continue to protect the QJSA. A participant may argue that this reduces his or her rights to take a distribution from the profit sharing account, because now he or she needs to obtain spousal consent to a non-QJSA distribution. Although this is factually correct, the IRS has ruled that adding a QJSA provision to a plan does not violate IRC §411(d)(6) even though, as a result of the amendment, a participant in the profit sharing plan will not be able to elect distribution in a form other than QJSA without his or her spouse's consent.

Under the QJSA rules, in the case of the participant's death before benefits commence, a QPSA is payable to the surviving spouse (unless the QPSA is waived). Some plans provide that, in the case of the preretirement death benefits provided by the plan, spousal consent is required only for the beneficiary of the portion of the death benefit that otherwise would have been payable under the QPSA. If the QJSA is being eliminated, remember that the spouse must be the beneficiary in full of any death benefits under the plan.[13] Therefore, the amendment of the plan to eliminate the QJSA also needs to modify the plan's provisions regarding spousal consent over beneficiary designations.

An amendment that eliminates a periodic payment option under a defined contribution plan may be applied immediately after the amendment is adopted, or on any later effective date specified under the terms of that amendment. The

[11] IRC §401(a)(11)(B)(iii)(III).

[12] See, the IRS Q&A Session at the 2002 ASPPA Annual Conference in Washington, D.C.

[13] IRC §401(a)(11)(B)(iii)(I).

amendment would not be able to take effect on a retroactive basis, so the immediate elimination of a periodic payment option could not affect a participant who, prior to the effective date of the amendment, had already commenced distribution.

Hardship withdrawal options not protected. A profit sharing plan or stock bonus plan, including a 401(k) arrangement under such plan, may be amended to eliminate a hardship withdrawal option or to modify the conditions for a hardship withdrawal without having to protect the pre-amendment option with respect to accrued benefits.[14]

Certain in-kind distributions may be eliminated. Generally, the medium of distribution is a protected benefit. For example, a plan that permits participants to direct their own investments into a selection of mutual funds may permit in-kind distributions so that participants do not have to liquidate their chosen investment to take a distribution.

However, a defined contribution plan may eliminate certain in-kind distribution options.[15] In particular, the regulations permit a defined contribution plan to be amended to modify the right to receive distribution in the form of marketable securities (other than securities of the employer) by substituting cash for the marketable securities. This rule does not permit the substitution of cash for the right to elect a distribution in the form of employer securities or in an investment that is not a marketable security, such as a limited partnership interest or real property, but amendments could be adopted to restrict the availability and eliminate the right to invest in such in-kind investments. If a participant's right to invest in employer securities is eliminated, the right to receive a distribution of such securities may be limited to the securities currently held in the participant's account.[16]

EXAMPLE 10-6. Elimination of In-Kind Distribution Option. A 401(k) plan currently allows participants to receive an in-kind distribution (or direct rollover) of the mutual fund investments made in their accounts. Effective January 1, 2018, the plan is amended to require that such distributions (or direct rollovers) be made in cash. The amendment does not protect the right to receive in-kind distributions with respect to current accrued benefits. The amendment does not violate the anti-cutback rules.

EXAMPLE 10-7. Right to Invest in Employer Stock is Eliminated. A profit sharing plan allows employees to direct the investment of their accounts. One of the investment options is employer stock. The plan allows distribution in the form of employer securities.

On February 1, 2018, the company amends the plan to eliminate the ability to invest in employer securities. No future contributions can be so invested and, once a participant elects to divest his or her account of employer securities, he or she is not permitted to reinvest in them. Concurrently with this amendment, the plan is amended to permit distributions in employer securities only to the extent that such securities are held in the participant's account at the time of the distribution.

The amendment is not an impermissible cutback, even though participants effectively have lost their option to receive benefit distributions in the form of employer securities.

EXAMPLE 10-8. Modification of Investment Options. Assume that a plan's participant-direction feature is modified to eliminate the right to make limited partnership investments. If that modification also requires a participant's account to divest the limited partnership investments, the participant's right to receive in-kind payment of such investments would be effectively eliminated. This is because, at the time of distribution in the future, the account would not hold such investments. Such a modification would not violate the anti-cutback rule by reason of the exception discussed above. Of

[14] Treas. Reg. §1.411(d)-4, Q&A-2(b)(2)(x), PLR 9743045 [elimination of a hardship withdrawal option on account balances transferred as part of a merger of two 401(k) plans did not violate IRC §411(d)(6)].
[15] Treas. Reg. §1.411(d)-4, Q&A-2(b)(2)(iii).
[16] Treas. Reg. §1.411(d)-4, Q&A-2(b)(iii).

course, if at the time of the modification of the investment option provisions of the plan the participant has a present right to distribution, he or she could divest the account of the limited partnership investments by electing an in-kind distribution of those investments at that time.

Prospective Elimination of Protected Benefit is Permitted

An optional form of benefit may be eliminated with respect to benefits that accrue after the amendment is adopted and effective.[17] In other words, IRC §411(d)(6) protection applies only to benefits already accrued at the time of the amendment. The same is true for early retirement benefits and retirement-type subsidies.

EXAMPLE 10-9. Prospective Elimination of Protected Withdrawal Right. A profit sharing plan permits participants who have reached age 55 to elect in-service withdrawals from their vested account balance attributable to employer contributions. Effective January 1, 2018, the plan is amended to eliminate this in-service withdrawal option. The amendment applies only to account balances attributable to post-2017 service.

In other words, the in-service-withdrawal option is still available with respect to a participant's account balance as of December 31, 2017. This amendment is not prohibited by IRC §411(d)(6) and no exception is necessary to allow this type of amendment. However, if the amendment also eliminates the in-service-withdrawal option with respect to the pre-2018 account balance, then the amendment would be in violation of IRC §411(d)(6).

Discretion by Employer Over Payment of Benefit Options Not Permitted

An employer may not have discretion to decide what optional forms of benefit will be made available to participants. This prohibition against discretion also applies to any person other than the participant and the participant's spouse such as the plan administrator, a retirement committee or the trustee.[18] In the Treasury's view, having the discretion to withhold an optional form of benefit would be tantamount to amending the plan to eliminate a protected optional form of benefit, which would violate IRC §411(d)(6).

Benefit Accrual for a Plan Year Under a Defined Contribution Plan

As a general rule, a participant has accrued a benefit for a plan year under a defined contribution plan after he or she satisfies the plan's allocation conditions in effect for that plan year. For example, if the plan requires employment on the last day of the plan year to receive an allocation, no benefit accrues for that plan year until the last day of the plan year. If the plan requires 1,000 hours of service as an allocation condition, but not employment on the last day of the plan year, the benefit accrues when the participant is credited with 1,000 hours for the plan year.

Accrual issues Relating to Defined Contribution Pension Plans

In a money purchase plan or target benefit plan, if an amendment to the contribution formula is made before any participant satisfies the allocation conditions for the plan year, the employer's funding requirement for the plan year may be determined under the amended formula without regard to any larger contribution that might have been required for that plan year if the pre-amendment formula had continued.[19]

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[17] Treas. Reg. §1.411(d)-4, Q&A-2(a)(1).

[18] Treas. Reg. §1.411(d)-4, Q&A-4 and Q&A-5.

[19] Prop. Treas. Reg. §1.412(b)-4(c)(4), Announcement 94-101, Rev. Rul. 79-237, 1979-2 C.B. 190, and PLR 8652036. Note that these citations actually address the termination of the plan during the plan year, but the rationale should be equally applicable to amendments that reduce the money purchase contribution formula, rather than freezing the formula or terminating the plan.

EXAMPLE 10-10. Plan Has Last-Day Employment Condition on Allocations. A money purchase plan requires 1,000 hours of service and employment on the last day of the plan year to receive an allocation of employer contributions. The contribution formula is 6 percent of compensation. The plan year ends December 31. On November 10, the employer amends the contribution formula to 4 percent of compensation. Because the accrual requirements under the plan include employment on December 31, the 6 percent contribution has not accrued to any participant. The amended formula of 4 percent may apply with respect to compensation for the entire plan year.

EXAMPLE 10-11. No Requirement to be Employed on the Last Day of the Plan Year for Allocations. Suppose, instead, that the plan in EXAMPLE 10-10 did not require employment on the last day of the plan year, but requires 1,000 hours of service for an allocation of employer contributions. Any employee who has 1,000 hours of service has a protected right to the 6 percent formula for that plan year (at least with respect to compensation earned through the effective date of the amendment).

Freezing or terminating the plan. If the amendment is to freeze or terminate the money purchase plan or target benefit plan, no funding would be required for that year if the plan has an employment on the last day condition for the allocation of employer contributions. If, in **EXAMPLE 10-10** above, the November 10 amendment is to freeze the money purchase formula or to terminate the money purchase plan, no benefits would accrue for the plan year and the employer's funding requirement would be zero dollars. When a money purchase plan or target benefit plan has an allocation condition of employment on the last day, the termination or freezing of the plan before the last day of the plan year results in no accruals for the current plan year. On the other hand, if the plan has no condition of employment on the last day of the plan year, but has a minimum hours condition for allocations, the termination or freezing would have to be effective before anyone has satisfied the hours requirement for the plan year to eliminate the employer's funding requirement for that year.

ERISA §204(h) notice. As will be discussed in more detail below, a pension plan must provide an advance notice to employees if an amendment will reduce the future rate of benefit accrual.[20] Under certain circumstances, benefits may continue to accrue under the old formula, even after the effective date of the amendment, if the notice requirements have not been satisfied. The determination of a participant's accrued benefit must be made by taking into account whether a failure to satisfy the ERISA §204(h) notice requirements has allowed the old formula to continue. An employer needs to plan ahead for amendments to the allocation formula under a money purchase plan or target benefit plan, to ensure that timely notice is provided to affected participants.

If You're Curious . . .

Compensation taken into account. If a benefit has accrued at the time the amendment is effective, presumably the protected benefit would be based on the compensation earned through the effective date of the new formula and not on the compensation for the entire plan year, but the IRS has not issued any formal guidance on this issue. Suppose the amendment in **EXAMPLE 10-11** above is effective on November 30. The protected benefit could be calculated as 6 percent of compensation paid through November 30. Each participant who had 1,000 hours of service by November 30 would be guaranteed the greatest of 6 percent of compensation for January 1 through November 30 (the protected benefit) or 4 percent of compensation for the entire plan year (the amended formula). Participants who have not completed 1,000 hours by November 30 would get the 4 percent contribution for the entire year's compensation, because such employees have no protected benefit for that year.

If the plan is terminating, it should be reasonable to disregard compensation after the termination date. To recognize compensation after the termination date of the plan would seem to contradict the concept of a plan termination and the fixing of funding liabilities as of the termination date.

[20] ERISA §204(h).

Retroactive reduction of benefit because of substantial business hardship. IRC §412(c)(8) provides a limited exception under which the benefit that accrued for a plan year may be retroactively reduced. IRC §411(d)(6) incorporates IRC §412(c)(8) by reference, as an exception to the anti-cutback rule.

Accrual Issues for Nonpension Plans

The principles discussed above for pension plans also apply to profit sharing or stock bonus plans, including 401(k) plans. However, if the employer's contribution is discretionary in a profit sharing or stock bonus plan, what has the employee really accrued after he or she satisfies the allocation requirements?

Suppose the employer makes a discretionary contribution after the close of the plan year. If the employer first adopts an amendment to change the allocation formula for the prior year, and then makes the contribution, can the contribution be allocated under the amended formula without violating the anti-cutback rule? Arguably, the amendment of the formula should not be an anti-cutback violation because the employer's contribution is discretionary. Because the employer could have decided simply to make no contribution at all, why should it not be able to modify the way its discretionary contribution will be allocated—as long as the amendment is adopted before the discretionary contribution is made—regardless of whether the participants have already satisfied the plan's allocation conditions? At least one court allowed contributions to a stock bonus plan to be allocated under an amendment adopted after the close of the plan year.[21]

Conversely, the IRS has ruled that the right to allocations under the plan's formula is protected once the employee has satisfied the allocation requirements under the plan, similar to the rule for money purchase and target benefit plans. Although the employer's contribution to the profit sharing plan might not be known at the time the participant has satisfied the allocation conditions (e.g., where the annual contribution amount is discretionary), the participant nonetheless has a protected allocable share of the yet-to-be-determined contribution.[22] While some practitioners agree with the court mentioned above and believe the IRS's position is unsupportable, the IRS has consistently taken this view.

EXAMPLE 10-12. Amendment Adopted After Close of Plan Year. A profit sharing plan allocates employer contributions using a pro rata formula based on compensation. The plan year ends December 31. Participants are entitled to an allocation of employer contributions for a plan year only if they are employed on December 31 of that year. On February 1, 2018, the employer amends the plan, effective retroactively to January 1, 2017, to change the allocation formula to a permitted disparity method. The employer then makes a discretionary contribution equal to $90,000.

If the pro rata allocation method had still been in effect, Roy's share of the $90,000 would have been $3,000. Under the permitted disparity allocation method, Roy's share is only $1,900. The IRS would view the amendment as a prohibited cutback under IRC §411(d)(6), because the participants had a protected allocable share of the $90,000 contribution that is based on the original pro rata allocation method. (In addition, the IRS has taken the position that amendments must be adopted before the end of the plan year to be effective for such year, with only limited exceptions. See below.)

EXAMPLE 10-13. Amendment Adopted Before Close of Plan Year and Plan Requires Employment on the Last Day of the Plan Year as Condition for Allocation. Suppose in the prior **EXAMPLE 10-12** that the amendment was adopted December 20, and was effective for the plan year ending December 31. Because the plan requires employment on December 31 to accrue a benefit, and the amendment is adopted before that date, Roy has not accrued a right to have his allocation calculated under the pro rata allocation method. The application of the permitted disparity formula would not be a cutback of accrued benefits with respect to Roy or any other participant whose allocation would have been greater under the pro rata allocation method.

[21] *Izzarelli v. Rexene Products Co*., 24 F.3d 1506 (5th Cir. 1994).

[22] TAM 9735001.

EXAMPLE 10-14. Amendment Adopted Before Close of Plan Year But No Requirement to be Employed on the Last Day of the Plan Year for Allocations. Suppose the profit sharing plan in the preceding examples does not require employment on December 31 to accrue a benefit. Instead, the only allocation requirement is to complete at least 1,000 hours of service for the plan year. If an amendment is adopted on December 20 to change the allocation formula, any participant who has already been credited with 1,000 hours of service for that year (which by December 20th should be most, if not all, eligible participants) arguably has a protected allocable share of the contribution under the pre-amendment formula. On the other hand, if the amendment is adopted before any participant has earned 1,000 hours for the plan year, none of the participants would have a protected allocable share.

If You're Curious . . .

Special issues for matching contributions. The determination of when benefits accrue creates some interesting issues for matching contributions. Clearly, if the plan requires 1,000 hours of service and/or employment on the last day of the plan year to receive an allocation of matching contributions for the plan year, the principles discussed above are applicable. So long as the matching contribution formula is amended before such conditions are satisfied, the employer should be able to reduce the matching contribution without violating the anti-cutback rule.

But what about a plan that does not have any allocation conditions? With a matching contribution, the employee must make a contribution [elective contribution under a 401(k) arrangement or an after-tax employee contribution] to receive the matching contribution. Arguably then, the employee does not actually accrue the matching contribution for IRC §411(d)(6) purposes until he or she makes the necessary contribution. If this is true, then the employer could reduce the matching formula for the remainder of a plan year, even after the plan's allocation conditions (if any) are satisfied, so long as the reduced matching formula applies only to contributions made after the date of the amendment.

EXAMPLE 10-15. Matching Formula Amended After Allocation Conditions Satisfied. A 401(k) plan provides for a 50 percent matching contribution on elective contributions. The plan year ends December 31. The plan does not require employment on December 31 as a condition for matching contributions, nor does it require completion of any minimum number of hours for the plan year. The employer amends the plan, effective July 1, to a 25 percent matching contribution formula. A reasonable argument is that the 50 percent formula is protected only for elective contributions made before the effective date of the amendment (i.e., the elective contributions made from compensation paid for the period January 1 through June 30). A more conservative approach would be to delay the effective date of the 25 percent formula to the next January 1 (i.e., the beginning of the next plan year) because the plan does not provide any allocation conditions on the match.

Conditions Relating to Death, Disability or Retirement

It is common for defined contribution plans to contain an exception to the normal allocation conditions when a participant dies, becomes disabled or has reached the plan's NRA before the end of the plan year. These conditions are protected in the same manner as other allocation conditions. These conditions must be taken into account to determine whether any contribution (or protected allocable share of a contribution) has been accrued prior to a plan amendment.

EXAMPLE 10-16. Accrual of Allocation in Money Purchase Plan With Last-Day Requirement. A money purchase plan requires employment on the last day of the plan year as a condition for alloca-

tion of employer contributions. However, if a participant dies or becomes disabled during the plan year, there is no last-day condition. The plan year ends September 30. On August 1, 2018, the plan is amended to reduce the employer contribution formula. One of the participants died on July 1, 2018. The reduced formula may not be applied to the deceased participant because, as of the date the amendment is effective, he has already completed the conditions for an allocation for the plan year ending September 30, 2018.

Amendments to Distribution Options

As discussed earlier, IRC §411(d)(6) protects not only benefits and allocations, but also certain distribution options. In particular, a plan cannot be amended to delay the distribution of accrued benefits to a date that is later than the original distribution date the plan provided at the time of the accrual. However, a defined contribution plan may change the distribution options (i.e., optional forms of benefit) available to a participant, such as the right to elect an annuity, lump sum or installment payment at the time that a distribution is requested. Optional forms of benefit may be eliminated from a defined contribution prospectively, even on accounts that have already been accrued.

If You're Curious…

Changing Default Procedures Regarding Plan Distributions

A plan will have one or more provisions that deal with how distributions are made to a participant who makes no election about how or when to receive his or her benefit. These default distribution provisions may be different for participants with small accounts (i.e., less than $1,000 or less than $5,000) than for larger accounts.

When a plan is amended to modify the default method by which the plan makes a distribution to a nonelecting participant, there is no elimination of an optional form of benefit and IRC §411(d)(6) is not violated.[23] For example, the IRS ruled that the amendment of the plan to change the default distribution procedure from a cash-out to the participant to a mandatory rollover to an IRA is not a cutback described in IRC §411(d)(6).[24] In other words, the amendment of a default option does not somehow take away a participant's "right" to the original default.

Merger or Transfer Cannot Eliminate Protected Benefit

If two plans are merged, the merged plan must continue to protect any IRC §411(d)(6) protected benefits with respect to the plans involved in the merger, unless an exception applies.

If plan assets of one plan are transferred in a direct trustee-to-trustee transfer to another plan, through a spinoff transaction (creating a new plan) or a transfer between existing plans, the transferee plan must continue any IRC §411(d)(6) protections that apply to the transferred benefits, unless an exception applies.[25]

If You're Curious . . .

Exceptions Under IRC §411(d)(6)(B) That Apply to Merger Transactions

First, there are exceptions to the elimination of benefit options in a defined contribution plan that were discussed earlier in this chapter. An exception may be utilized coincident with a merger transaction. For example, if two defined contribution plans are being merged, and those plans have different

[23] Notice 2000-36.

[24] IRS Notice 2000-36, IRS Notice 2005-5.

[25] Treas. Reg. §1.411(d)-4, Q&A-3; see also, Hunter v. Caliber Systems, Inc., 25 EBC 1301 (6th Cir. August 2, 2000).

payment options with respect to the distribution of benefits, the exception could be used to eliminate one or more periodic payment options under those plans, provided the conditions of that exemption are met by the merged plan.

There is also a right to eliminate in-kind distribution options under a defined contribution plan and the right to eliminate or modify hardship withdrawal options in a profit sharing plan or stock bonus plan.

Ancillary Benefits and Rights and Features Are Not Protected by IRC §411(d)(6) if They Are Not Optional Forms of Benefit

IRC §411(d)(6)(B) protects only optional forms of benefit, early retirement benefits and retirement-type subsidies. It does not protect ancillary benefits or rights and features that are not optional forms of benefit under the plan.

Definition of Ancillary Benefits

An ancillary benefit is any of the following:

- A social security supplement;
- A disability benefit that is not in excess of a qualified disability benefit (i.e., a disability benefit provided by the plan that does not exceed the benefit that would be provided for the participant if he or she separated from service at NRA[26]);
- A life insurance benefit;
- A medical benefit;
- A death benefit (other than a death benefit that is part of an optional form of benefit, such as a survivor annuity component of a joint and survivor annuity form of benefit); or
- A plant shutdown benefit or other similar benefit that does not continue past retirement age and does not affect the payment of the accrued benefit.[27]

Because ancillary benefits are not protected under IRC §411(d)(6), they may be eliminated even with respect to accrued benefits.[28]

The forfeiture of benefits upon the death of a participant is not a violation of the minimum vesting standards under IRC §411(a).[29] Of course, the QJSA and QPSA survivor annuity requirements are not permitted to be forfeited from a pension plan.[30]

Rights and Features

Rights and features under the plan that are not optional forms of benefit are not protected from elimination under this rule. Thus, they may be eliminated by plan amendment at any time. These include:

- The availability of participant loans;
- The right to direct investments;
- The right to make after-tax employee contributions;
- The right to make elective contributions under a 401(k) arrangement;
- The right to a particular form of investment (e.g., employer securities);
- Allocation dates and valuation dates under the plan; and

[26] IRC §411(a)(9).
[27] Treas. Reg. §1.401(a)(4)-4(e)(2).
[28] Treas. Reg. §1.411(d)-4, Q&A-1(d).
[29] IRC §411(a)(3)(A).
[30] IRC §411(a)(3)(A).

- Rights that derive from administrative and operational provisions (e.g., mechanical procedures for allocating investment experience among account balances in a defined contribution plan).[31]

EXAMPLE 10-17. Elimination of Loan Program. A company amends its 401(k) plan, effective July 1, 2018, to eliminate the participant loan program. As of July 1, 2018, no new loans may be made from the plan, and no existing loans may be renegotiated, extended or consolidated. This amendment does not violate IRC §411(d)(6) even though the amendment does not protect the right to take loans with respect to benefits already accrued. Participant loans are not optional forms of benefit because a loan feature does not allow an employee to receive distribution of his or her benefits. When an employee takes a participant loan, the employee is merely borrowing part of his or her account, not receiving a distribution from the account. This is true even though the loan might be taxed as a deemed distribution, pursuant to IRC §72(p), if the conditions of IRC §72(p)(2) are not satisfied.

An offset against a participant's account balance is an actual distribution. Thus, a provision in a profit sharing plan that provides for execution of the plan's security interest against the participant's account (i.e., offset) upon default on the loan is an IRC §411(d)(6)(B) protected benefit.[32] Suppose the profit sharing plan in the above EXAMPLE 10-18 has such a provision. If a loan that existed at the time of the amendment goes into default, the plan's provision would require an offset against the account, and the amendment could not eliminate such optional form of benefit, to the extent of the account balance as of July 1, 2018, that is securing the loan.

EXAMPLE 10-18. Change in Investment Options. A company is moving its 401(k) plan to a new investment vendor that will offer a different set of investment options to participants than was offered previously. The change is effective March 1, 2018. As of that date, all existing investments will be converted into the most similar investment option offered with the new vendor. There is no IRC §411(d)(6) violation because the change relates to investment options, not to optional forms of benefit.

In a situation like this, it is possible that there may be a suspension of investment direction rights for a period of more than three consecutive business days (called a blackout period), that will require an advance notice to participants, pursuant to ERISA §101(i). However, the requirement to provide a blackout notice does not change the fact that the elimination of the previously-available investment options is not an IRC §411(d)(6) issue.

EXAMPLE 10-19. Change in Valuation Dates. A calendar year profit sharing plan, that is funded solely with discretionary employer contributions and is not participant-directed, values trust assets as of each December 31. A distribution made during the year is based on the prior December 31 valuation, unless the plan administrator calls for a special valuation (which is authorized in the plan document). Because of a significant downturn in investments during 2016, the plan administrator calls for monthly valuations during the 2016 plan year.

Lara terminates employment in May 2018 and requests a plan distribution. The distribution is made in September 2018, based on the August 31, 2018, valuation. The valuation of Lara's account balance as of August 31, 2018, is 8 percent less than it was on December 31, 2017. The interim monthly valuations called for by the plan administrator, pursuant to its discretion in the plan, are not a cutback of a protected optional form of benefit. The same result would apply if the plan had been amended in January 2018, to change the annual valuation date provision in the plan to a monthly valuation date provision.

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[31] Treas. Reg. §1.411(d)-4, Q&A-1(d).

[32] Treas. Reg. §1.411(d)-1, Q&A-1(b)(2), Example 11, and (d)(4).

If You're Curious . . .

The exercise of an interim valuation provision is a fiduciary issue. When distributions are based on a prior valuation that does not reflect subsequent poor performance of the trust's investments, a plan making substantial distributions before the next valuation date may be providing a windfall to the participants receiving the distributions at the expense of the participants who are not receiving such distributions. To carry out his or her duties in a prudent manner, the responsible fiduciary must take this into consideration, consulting legal counsel if necessary.

Although Treas. Reg. §1.411(d)-4, Q&A-1(d)(8) specifically provides that dates for valuing account balances are not protected optional forms of benefit under IRC §411(d)(6), be careful! If a participant has already elected distribution (or has the right to elect distribution) based on the last valuation date, a change in the valuation of the account balance due to a plan amendment could be construed as a violation of IRC §411(d)(6). For example, suppose an employer amended the plan to adopt a new valuation date in response to the stock market crash in October 2008. The application of that amendment to a participant who had terminated employment prior to the amendment and had already fixed his or her right to distribution based on the prior valuation date, would violate IRC §411(d)(6).[33]

CORRECTIVE AMENDMENTS

If the contributions or benefits under the plan are discriminatory, the plan fails to pass the coverage rules of IRC §410(b) or if the availability of benefits, rights and features is discriminatory, corrective action may be taken within 9½ months after the close of the plan year (e.g., October 15 following the end of a calendar plan year).[34] If a determination letter is requested within the 9½-month period, the time to adopt corrective amendments is extended to 91 days after the issuance of the letter, in the same manner as provided for an extension of the remedial amendment period in Treas. Reg. §1.401(b)-1(d)(3).[35]

Corrective Amendments to Satisfy Coverage or Make Contributions or Benefits Nondiscriminatory

If a plan fails nondiscrimination testing under IRC §401(a)(4) or coverage testing under IRC §410(b), correction must be made. Coverage testing may be failed if the plan excludes certain groups of employees—such as hourly employees or terminated employees with more than 500 hours of service. Failures of nondiscrimination testing occur most often when a plan design is unique and uses some of the more complex nondiscrimination testing options (referred to as general testing). A corrective amendment in these circumstances may increase contributions or benefits, or add participants, so that the plan can satisfy the coverage rules and/or one of the nondiscrimination testing options available.

Accrued benefits may not be reduced to correct discrimination. For example, the plan cannot be amended to eliminate or reduce the prior year's benefit accrual for an HCE so that the general test can be satisfied. The terms of the plan for accruing benefits, and the timing of the amendment, will be relevant in determining whether an amendment reduces accrued benefits. A reduction of accrued benefits would violate the anti-cutback rule under IRC §411(d)(6) and ERISA §204(g).

Any additional allocation or benefit accrual resulting from the corrective amendment generally must be able to satisfy IRC §401(a)(4) when tested separately.[36] However, this rule does not apply if the amendment is for the purpose of conforming the plan to one of the safe harbor tests.[37]

[33] Boyertown Casket Co. Thrift and Profit Sharing Plan, 14 EBC 2464 (E.D.Pa. 1991).
[34] Treas. Reg. §1.401(a)(4)-11(g).
[35] Treas. Reg. §1.401(a)(4)-11(g)(2)(iv)(B).
[36] Treas. Reg. §1.401(a)(4)-11(g)(3)(v)(A).
[37] Treas. Reg. §1.401(a)(4)-11(g)(3)(v)(B).

Amendment Must Have Substance

The amendment must have substance for the affected employees.[38] If an amendment provides additional contributions or benefits to a nonvested employee who terminated employment on or before the close of the plan year to which the amendment relates, the amendment is not effective at solving the nondiscrimination or coverage problem, because the employee would not have received any economic benefit from such amendment (i.e., the employee will forfeit the benefit being provided through the amendment). Therefore, if benefiting a former employee is critical to curing the nondiscrimination violation, and that employee would be zero percent vested in the benefit, the amendment should at least partially vest the benefit being provided through the corrective amendment.

Corrective Amendments to Make a Benefit, Right or Feature Available on a Nondiscriminatory Basis

The corrective amendment will be treated as curing the discriminatory availability of a benefit, right or feature (BRF) if the group of employees to whom the BRF is available is expanded so that the BRF satisfies the nondiscriminatory availability test. Alternatively, the corrective amendment may eliminate the BRF. If the amendment eliminates the BRF, it must be adopted by the last day of the plan year in which the discrimination arose (not the 9½-month period following the close of such plan year). Any corrective amendment to cure discriminatory availability must remain in effect at least until the end of the first plan year beginning after the date of the amendment. The corrective amendment cannot be part of a pattern of amendments used to correct repeated failures.[39]

EXAMPLE 10-20. Correction of Discriminatory BRF. A calendar year profit sharing plan makes investment direction available to participants who are at least 50 years old. It is determined that the age 50 requirement results in discriminatory availability for the plan year ending December 31, 2017. On September 1, 2018, the employer adopts an amendment to lower the age requirement to 40. This amendment expands the group of employees who have investment direction available, satisfying the nondiscriminatory availability test under Treas. Reg. §1.401(a)(4)-4. Because the amendment is adopted by October 15, 2018, and does not eliminate the BRF, it may be treated as in effect for 2017 in determining whether the participant-direction feature was currently available on a nondiscriminatory basis. The amendment must remain in effect at least until December 31, 2019 (i.e., the end of the plan year following the year of adoption of the amendment).

Alternatively, the employer could eliminate the participant-direction feature to cure the defect, but the amendment would have to be adopted no later than December 31, 2017 (i.e., the end of the plan year in which the availability of the investment direction feature was discriminatory), and remain in effect at least through the end of the next plan year (i.e., through December 31, 2018).

AMENDMENT DEADLINES AND THE REMEDIAL AMENDMENT PERIOD

As discussed in earlier chapters, a plan document must be in writing to be qualified, and the written document must include certain provisions and must not include other provisions. Notwithstanding a document writer's best efforts, there may be times when the document does not comply with the law.

Whenever the law changes, there is a period during which a practitioner may update the plan to conform to new qualification rules, without the plan being subject to disqualification in the interim. This period is called the **remedial amendment period**. Amendments during the remedial amendment period that will conform the plan to the legal requirements may be made retroactively effective as required by the law. Generally, the laws outline the date by which conforming amendments must be adopted. For example, changes made by the Pension Protection Act of 2006 (PPA)

[38] Treas. Reg. §1.401(a)(4)-11(g)(4).
[39] Treas. Reg. §1.401(a)(4)-11(g)(3)(vi).

did not have to be documented until 2009; the interim period was the PPA remedial amendment period.[40]

Remedial amendment periods also apply whenever a new plan is adopted or amended. These remedial amendment periods permit the plan sponsor to submit the plan to the IRS for a favorable determination letter and, if the IRS requires modifications to the plan or amendment language, to make those changes retroactively.

The IRC provides general rules for the adoption of new plans and amendments to existing plans and the related remedial amendment periods. However, these rules have been overridden by Revenue Procedure 2007-44, which was designed to make the restatement and submission procedures associated with legislative changes easier to understand.

Generally, an amendment must be adopted by the last day of the plan year in which the amendment is effective.[41] This deadline applies for all discretionary amendments—that is, all amendments that are not required because of a change in the law affecting qualification requirements. If the amendment is not discretionary—that is, the amendment is required due to changes in the qualification requirements or is closely associated with such requirements—the deadline is outlined in the Rev. Proc. 2007-44 procedures. This deadline for adoption of these types of amendments (called interim amendments) is usually the tax return due date (including extensions) for the tax year including the end of the first plan year during which the plan was so affected. However, as noted above, the law or regulation that created the qualification change may state a different date. Alternatively, IRS guidance may permit these qualification changes to be adopted prior to the end of the six-year amendment cycles for pre-approved plans.

If You're Curious . . .

Six-Year Remedial Amendment Period Cycles

The remedial amendment period for changes in the law has been modified to be a given date in a six-year cycle for pre-approved plans.

Changes to Cycles for Individually Designed Plans

Effective January 1, 2017, the IRS will eliminate the staggered 5-year determination letter remedial amendment cycles for individually designed plans. They will also limit the scope of the determination letter program for individually designed plans to initial plan qualification and qualification upon plan termination. See Chapter 1 for more information.

Interim Amendments

As mentioned above, discretionary amendments must be adopted by the end of the plan year in which they are effective. Generally, legally required amendments must be adopted before the end of the applicable remedial amendment period. However, sometimes, legally required amendments must be adopted earlier. This occurs in two circumstances: (i) when the legally required amendment may be applied earlier, in the employer's discretion, in which case the amendment may need be adopted earlier; or (ii) when there is an issue under IRC §411(d)(6).

For example, if a money purchase plan has a formula under which participants are entitled to a contribution allocation of 10 percent of compensation, an amendment to reduce this formula must be adopted before the participants accrue a right to the 10 percent formula under IRC §411(d)(6), notwithstanding the fact that this amendment may be made in the middle of a remedial amendment period.

The amendment provisions for PPA permitted interim amendments to conform plans to that law to be delayed until 2009. The PPA rules further provided that the IRS could impose interim amendment deadlines when it deemed necessary. No such deadlines have been imposed at this time. Interim amendments were required, however, to conform

[40] PPA §§1107(b)(1)(A) and (2)(B).

[41] Rev. Proc. 2005-66, 2005-37 I.R.B. 509, §5.05(3).

plans to the Heroes Earnings Assistance and Relief Tax Act (HEART) and the Worker, Retiree and Employer Relief Act (WRERA).

SUMMARIES OF MATERIAL MODIFICATION

A **summary of material modifications** (SMM) is required when there has been a material modification to the plan or when the information provided in the summary plan description (SPD) has changed. The summary must explain the amendment or change in a manner that can be reasonably understood by the average participant.

Timing of SMM Distribution

The plan administrator must provide a copy of the SMM to each participant and each beneficiary entitled to benefits under the plan no later than 210 days after the close of the plan year in which the amendment was adopted.[42] Note that this means that an amendment adopted in a plan year that is retroactive to an earlier year will control the due date of the SMM, not the effective date of the amendment.

If a participant or beneficiary is receiving the SPD for the first time, any previously prepared SMMs that describe amendments that have not yet been incorporated into the SPD should accompany that SPD. No SMM is required if the change is incorporated into an SPD that is delivered to participants prior to the deadline of the SMM.

What Is a Material Modification?

The regulations do not describe what amendments or changes are considered material. Common sense should prevail here. If in doubt, the plan administrator should err on the side of disclosure. Examples of changed provisions that should be disclosed in an SMM include:

1. Eligibility and/or vesting provisions;
2. Allocation or benefit formula;
3. Conditions for accruing benefits or receiving an allocation;
4. Distribution options;
5. New trustees, plan administrator, employer sponsor or other named fiduciary;
6. Participant loan program;
7. Adoption of a 401(k) arrangement or an after-tax employee contribution feature;
8. Adoption of a participant-directed investment option; or
9. Benefit claims procedures.

SMMs do not have to be provided to retired participants, beneficiaries receiving benefits or separated participants entitled to benefits if the modification in no way affects their rights under the plan.[43]

Enforcement of SMM Requirements

ERISA does not impose civil penalties on a plan administrator for failure to comply with the SMM requirement. However, the DOL may request a copy of the SMM, and a $100-per-day penalty ($1,000 maximum) applies to a failure to produce such document within 30 days of the request.[44]

ERISA §204(h) NOTICE

Notice must be given to participants and beneficiaries of any amendment that:

1. Significantly reduces (or ceases) the rate of future benefit accrual under a pension plan; <u>or</u>

[42] DOL Reg. §2520.104b-3(a).
[43] DOL Reg. §2520.104b-4(c).
[44] ERISA §§104(a)(6) and 502(c)(6).

2. Becomes effective on or after June 7, 2001, and eliminates, ceases, or significantly reduces an early retirement benefit or retirement-type subsidy [as defined in IRC §411(d)(6)(B)(I)].

For purposes of our discussion, we will refer to an amendment described in the preceding sentence as an **ERISA §204(h) amendment**. The notice required by ERISA §204(h) is referred to in these materials as the **ERISA §204(h) notice**. The various issues that arise with regard to the ERISA §204(h) notice include:

1. determining whether an amendment is an ERISA §204(h) amendment;
2. the deadline for giving the ERISA §204(h) notice;
3. the contents of the ERISA §204(h) notice;
4. who must receive the ERISA §204(h) notice;
5. the consequences of not providing the ERISA §204(h) notice, including an excise tax under IRC §4980F;
6. the manner in which the notice is given; and
7. special issues regarding plan terminations and mergers.

The notice requirements set forth in ERISA §204(h) are duplicated in IRC §4980F. The Treasury is responsible for issuing regulations under both sections. This is why the governing regulations are under IRC §4980F.

What Amendments Invoke the ERISA §204(h) Notice Requirements?

An ERISA §204(h) notice is required only when an ERISA §204(h) amendment is adopted under a pension plan. A pension plan for this purpose means a defined benefit plan, a money purchase plan or any other defined contribution plan that is subject to the minimum funding requirements under IRC §412.[45] Thus, a nonpension plan, such as a profit sharing plan or stock bonus plan, is never subject to the ERISA §204(h) notice requirement. This is true even if the amendment is to a fixed contribution formula [e.g., an amendment to lower a stated matching contribution under a 401(k) plan].

Furthermore, the ERISA §204(h) notice requirement and the excise tax provisions under IRC §4980F are not applicable with respect to:

- Governmental plans, as described in IRC §414(d), or
- A church plan that has not elected to be covered by ERISA (a nonelecting church plan).[46]

ERISA §204(h) is part of Title I of ERISA and these plans are exempt from Title I.[47]

A pension plan that has fewer than 100 participants and that covers no participants who are employees under DOL rules (such as a plan that covers only the partners and their spouses)[48] is not subject to ERISA §204(h) and IRC §4980F.[49] For example, a money purchase plan that is eligible to file Form 5500-EZ because it is a one-participant plan is exempt from these requirements.

Reduction or Cessation of Future Rate of Benefit Accrual

Under a money purchase plan or target benefit plan, the amendment must affect the amount of future allocations of employer contributions and/or forfeitures to participants' accounts for ERISA §204(h) notice requirements to apply.[50] Examples of provisions that affect future allocations are: the formula for determining the amount of allocations of employer contributions and forfeitures, the rate of disparity in a permitted disparity formula under IRC §401(l), the exclusion of current participants from future participation and the actuarial assumptions used to calculate contribu-

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[45] ERISA §204(8)(B); IRC §4980F(f)(2); and Treas. Reg. §54.4980F-1, Q&A-3.
[46] Treas. Reg. §54.4980F-1, Q&A-3(a).
[47] ERISA §4(b)(1) and (2).
[48] See, DOL Reg. §2510.3.
[49] Treas. Reg. §54.4980F-1, Q&A-3(b).
[50] Treas. Reg. §54.4980F-1, Q&A-6(b)(2).

tions under a target benefit plan.[51] Changes in the investments or investment options under the plan are not taken into account to determine if there is a significant reduction in the rate of future benefit accrual.[52]

Significant Reduction

To invoke an ERISA §204(h) notice requirement, the amendment described above must result in a significant reduction. The significance of the reduction must be determined on the basis of reasonable expectations, taking into account the relevant facts and circumstances at the time the amendment is adopted.[53]

For a defined contribution pension plan, the significance of the reduction is determined by comparing the amounts to be allocated under the amendment with the amounts that would be allocated if the amendment was not adopted.[54] Because the significance of the amendment is open to subjective interpretation, the prudent approach usually is to provide the notice when the rate of future benefit accrual is reduced (or potentially reduced) by the amendment, even if it is not clear whether the reduction is significant. Arguing the lack of significance of the reduction might be important if notice was not provided, but the IRS, the Employee Benefit Security Administration (EBSA), a fiduciary, a plan participant or a beneficiary is of the opinion that notice was required.

A complete cessation of future accruals (i.e., discontinuance of accruals because the plan is frozen or terminated) is always significant.[55] An amendment that affects the optional forms of benefit available under a pension plan (other than early retirement benefits or retirement-type subsidies), or an amendment that affects ancillary benefits or rights and features, is not an ERISA §204(h) amendment.[56] Also, an amendment that eliminates a benefit that is not protected under IRC §411(d)(6) or an IRC §411(d)(6)-protected benefit that may be eliminated,[57] is not an ERISA §204(h) amendment.[58] For example, an amendment would not require an ERISA §204(h) notice if it: (1) eliminates or reduces the availability of participant loans, (2) modifies or eliminates investment-direction options under a defined contribution plan, (3) relates to the plan's vesting schedules, (4) eliminates or restricts the right to make after-tax employee contributions or elective contributions (e.g., under a pre-ERISA money purchase plan) or (5) eliminates a periodic payment option under a defined contribution plan.

An amendment to convert a money purchase plan to a profit sharing plan (or any other individual account plan that is not subject to IRC §412, such as a stock bonus plan) is in all cases deemed to be an amendment that provides for a significant reduction in the rate of future benefit accrual.[59] A merger of the plans is treated as a conversion for this purpose. The ERISA §204(h) notice is required regardless of the contribution formula under the profit sharing plan.

EXAMPLE 10-21. Conversion or Merger. An employer maintains a money purchase plan and no other qualified plan. The employer decides to amend the money purchase plan into a profit sharing plan, effective January 1, 2018. The formula under the money purchase plan is 20 percent of compensation. The employer must provide the ERISA §204(h) notice within a reasonable time prior to January 1, 2018 (the effective date of the conversion). This is true regardless of whether, following the conversion, the contribution formula under the profit sharing plan is discretionary or fixed (even if the fixed formula is at least 20 percent of compensation). The same rules apply if the employer decides to merge a money purchase plan into an existing profit sharing plan.

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[51] Treas. Reg. §54.4980F-1, Q&A-7(a)(1).
[52] Treas. Reg. §4980F-1, Q&A-6(b)(2), last sentence.
[53] Treas. Reg. §4980F-1, Q&A-8(a).
[54] Treas. Reg. §54.4980F-1, Q&A-8(b).
[55] Treas. Reg. §54.4980F-1, Q&A-17.
[56] Treas. Reg. §54.4980F-1, Q&A-6(b)(3).
[57] Treas. Reg. §1.411(d)-4, Q&A-2(a) or (b).
[58] Treas. Reg. §4980F-1, Q&A-7(b).
[59] Rev. Rul. 2002-42, Treas. Reg. §54.4980F-1, Q&A-8(b) (last sentence).

Deadline for Giving the ERISA §204(h) Notice

The statute provides that the notice must be given within a reasonable time before the effective date of the amendment.[60]

Deadlines Prescribed by Regulations: 45-Day Notice is General Rule

The regulations issued under IRC §4980F define a reasonable time generally to be no less than 45 days before the effective date of the ERISA §204(h) amendment, subject to a number of exceptions.[61]

Note that the amendment may be adopted after the notice is given, so long as the notice is given within the required reasonable time before the effective date of the amendment, and the amendment actually adopted does not contain any material modification of the amendment described in the notice.[62]

15-day period for small plans. A small plan is not required to provide the notice until 15 days before the effective date of the amendment.[63] A **small plan** is defined in the regulations as a plan that is reasonably expected to have fewer than 100 participants with accrued benefits as of the effective date of the ERISA §204(h) amendment.

EXAMPLE 10-22. Notice for an Amendment to a Small Plan. Corporation T sponsors a money purchase pension plan that has 75 participants. Corporation T wants to amend its plan to change the contribution formula from 10 percent of compensation to 5 percent, effective January 1, 2018.

On or before December 16, 2017 (15 days before the amendment's effective date), Corporation T must provide notice to its participants, advising them that the formula is going to be materially reduced for future contributions after January 1, 2018. Such notice will meet the timing rules required for the ERISA §204(h) notice. The actual amendment need not be adopted until after the notice is provided, but before any participant accrues the right to the larger contribution.

EXAMPLE 10-23. Notice of Amendment for a Large Plan. Corporation B sponsors a pension plan covering all of its 5,000 employees. Corporation B has determined it is necessary to reduce the plan formula for the plan, effective January 1, 2018. Corporation B must provide its ERISA §204(h) notice on or before November 16, 2017, 45 days before the amendment's effective date.

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15-day period for certain business transactions. If an ERISA §204(h) amendment is being adopted in connection with an acquisition or disposition described in Treas. Reg. §1.410(b)-2(f) (i.e., any stock or asset acquisition, merger, or other similar transaction that involves a change in employer of the employees of a trade or business), the notice period also is 15 days before the effective date of the amendment, regardless of the size of the plan.[64]

Notice period ends after effective date of amendment for certain plan mergers affecting only early retirement benefit or retirement-type subsidy. If an ERISA §204(h) amendment is adopted with respect to liabilities being transferred to another plan in connection with a business transaction described above, and the amendment significantly reduces an early retirement benefit or retirement-type subsidy but not the rate of future benefit accrual, the notice must be provided no later than 30 days after the effective date of the amendment.[65]

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[60] ERISA §204(h)(3); IRC §4980F(e)(3).
[61] Treas. Reg. §54.4980F-1, Q&A-9(a).
[62] ERISA §204(h)(5); IRC §4980F(e)(5).
[63] Treas. Reg. §54.4980F-1, Q&A-9(b).
[64] Treas. Reg. §54.4980F-1, Q&A-9(d)(1).
[65] Treas. Reg. §4980F-1, Q&A-9(d)(2).

15-day notice period for multiemployer plans. A 15-day notice rule also applies to multiemployer plans [as defined in IRC §414(f)].[66]

If participants have a choice between the old and new benefit formulas, the notice periods described above still apply even though it is possible that a participant will choose the old formula and not have a significant reduction in the rate of future benefit accrual.[67]

Contents of the ERISA §204(h) Notice

The ERISA §204(h) notice must include sufficient information to allow applicable individuals to understand the effect of the plan amendment, including the approximate magnitude of the expected reduction for the individual.[68] The notice content is affected by the complexity of the amendment, and the potential variability of the amendment's effect on participants and alternate payees. As with all ERISA-mandated disclosures, the notice:

- Must be written in a manner that is reasonably calculated to be understood by the average participant, and
- Must apprise the individual of the significance of the notice.[69]

Required Narrative

An ERISA §204(h) amendment that affects the future rate of accrual must include, at a minimum:

- A description of the old formula;
- A description of the new formula; and
- The effective date.[70]

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Different Information for Different Classes

If an ERISA §204(h) amendment affects different classes of applicable individuals differently, separate ERISA §204(h) notices may be prepared so that each applicable individual receives a notice that pertains to that individual and omits information that does not apply to that individual. Each notice must identify the class or classes of participants to whom it is provided.[71] Alternatively, information about all classes may be provided in the same ERISA §204(h) notice, but the notice must include sufficient information to enable a participant to understand the class in which he or she is included.[72]

Who Must Receive the ERISA §204(h) Notice?

The ERISA §204(h) notice does not necessarily have to be provided to all plan participants and beneficiaries. Instead, the notice is required for each applicable individual. An **applicable individual** is:

- Each participant or alternate payee under a qualified domestic relations order (QDRO) whose rate of future benefit accrual is reasonably expected to be significantly reduced, or for whom an early retire-

[66] Treas. Reg. §4980F-1, Q&A-9(c).
[67] Treas. Reg. §4980F-1, Q&A-9(e).
[68] ERISA §204(h)(2); IRC §4980F(e)(2), Treas. Reg. §54.4980F-1, Q&A-11(a)(1) and (4).
[69] Treas. Reg. §54.4980F-1, Q&A-11(a)(2).
[70] Treas. Reg. §54.4980F-1, Q&A-11(a)(2)(I).
[71] Treas. Reg. §54.4980F-1, Q&A-11(a)(6)(ii).
[72] Treas. Reg. §54.4980F-1, Q&A-11(a)(6)(I).

ment benefit or retirement-type subsidy may reasonably be expected to be significantly reduced, by the ERISA §204(h) amendment, and

- Each employee organization (i.e., union) that represents participants in the plan.[73]

Facts-and-Circumstances Test to Determine Who is Reasonably Expected to be Affected by the Amendment

When determining whether an ERISA §204(h) amendment is reasonably expected to affect an applicable individual, all relevant facts and circumstances must be considered.[74]

Determination Date for Applicable Individuals

The identity of the applicable individuals may be determined with reference to the facts and circumstances on a typical business day that is reasonably proximate to the time that the ERISA §204(h) notice is provided (or the latest date for timely providing the notice, if earlier).[75] No maximum or minimum time frame is provided in the regulations for determining whether a date is reasonably proximate to the notice date.

EXAMPLE 10-24. Determination Date of First Day of the Month During Which Notice is Provided. A pension plan is amended, effective January 1, 2018, to significantly reduce the rate of future benefit accrual. Notice was provided to applicable individuals on October 31, 2017. The identity of the applicable individuals was determined on October 1, 2017, taking into account the workforce on that date and other relevant facts and circumstances on that date. Because October 1 is a typical business day that is reasonably proximate to the date of the notice, the notice requirement is satisfied.[76]

Consequences of Failing to Provide ERISA §204(h) Notice on a Timely Basis

There are two significant consequences of a failure to give an ERISA §204(h) notice: an excise tax and a potential for limited effectiveness of the amendment.

Excise Tax Imposed on Notice Failures

The primary consequence of failing to provide the ERISA §204(h) notice for an amendment is that an excise tax under IRC §4980F is imposed on the employer.[77]

Amount of the tax. The excise tax is $100 for each day in the noncompliance period per applicable individual with respect to whom a notice failure has occurred.[78] The **noncompliance period** is the period beginning on the date the notice failure occurs (i.e., the date as of which notice should have been given) and ending on the date the notice is provided or the failure is otherwise corrected.[79] For example, if the notice was not provided to 100 applicable individuals, the penalty would be $10,000 for each day in the period during which none of those individuals received notice (i.e., $100 per day times 100 individuals).

Liability for tax. The employer is liable for reporting and paying the tax or, in the case of a multiemployer plan, the plan

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[73] ERISA §204(h)(8)(A); IRC §4980F(f)(1) and Treas. Reg. §54.4980F-1, Q&A-10. Also see Davidson v. Canteen Corp., 957 F.2d 1404 (7th Cir. 1992), which held the notice requirement applies even if the only employees affected by the amendment are HCEs.
[74] See, Treas. Reg. §54.4980F-1, Q&A-10(f), examples.
[75] Treas. Reg. §54.4908F-1, Q&A-10(e).
[76] Treas. Reg. §54.4980F-1, Q&A-10(f), Example 8.
[77] IRC §4980F(a).
[78] IRC §4980F(b)(1).
[79] IRC §4980F(b)(2).

is liable for reporting and payment of the tax.[80]

Exceptions to the excise tax. The statute includes several exceptions to the excise tax.

- Excise tax relief for certain unknown failures. If the Treasury determines that a person who is liable for the tax did not know the failure existed and exercised reasonable diligence to satisfy the notice requirements, no excise tax is imposed.[81] A failure is "not known to have existed" only if the person exercised reasonable diligence in attempting to deliver the ERISA §204(h) notice by the applicable deadline, and at the latest date permitted for delivery, the person reasonably believed that notice was actually delivered to each applicable individual by that date.[82]
- Excise tax relief for certain failures corrected within 30 days. If the person liable for the tax exercised reasonable diligence to satisfy the notice requirements, but notice was not given to one or more applicable individuals, no excise tax is imposed if notice is given to such individual(s) within 30 days after the person knew (or would have known, exercising reasonable diligence) that the failure existed.[83] An example in the regulations involves a situation where an overnight delivery service that is used to deliver the ERISA §204(h) notices fails to make timely delivery to appropriate personnel at one worksite so that such personnel could hand deliver the notices to the employees at that worksite. Assuming that within 30 days after the employer first knows (or should have known by exercising reasonable diligence) of the failure, the ERISA §204(h) notices are delivered to employees at that worksite, no excise tax applies.[84]

Cap on excise tax for unintentional failures. If reasonable diligence was exercised to satisfy the notice requirements, but the above exceptions are not available, the excise tax imposed with respect to failures during a taxable year of the employer (or taxable year of the trust, in the case of a multiemployer plan) will not exceed $500,000.[85]

Waiver by Treasury. The Secretary of Treasury is authorized to waive all or part of the excise tax if:

- The failure is due to reasonable cause and not to willful neglect; and
- The Secretary determines that payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

A request for a waiver should be submitted to the IRS in the form of a private letter ruling request.[86]

Benefits Continue to Accrue Under Old Formula for Egregious Failures

If there is an egregious failure of the notice requirements, the provisions of the plan must be applied as if the plan amendment entitled all applicable individuals to the greater of: (1) the benefits to which they would have been entitled without regard to the amendment; or (2) the benefits under the plan, determined in accordance with the amendment.[87] This consequence is in addition to any applicable excise tax under IRC §4980F.[88]

There is an **egregious failure** to satisfy the notice requirement if such failure is within the control of the plan sponsor and satisfies any of the following descriptions:

- The failure is intentional (including a failure to promptly provide the required notice or information after the plan administrator discovers an unintentional failure);

[80] IRC §4980F(d) and Treas. Reg. §54.4980F-1, Q&A-15(a).
[81] IRC §4980F(c)(1).
[82] Treas. Reg. §54.4980F-1, Q&A-15(b).
[83] IRC §4980F(c)(2).
[84] Treas. Reg. §54.4980F-1, Q&A-15(c).
[85] IRC §4980F(c)(3).
[86] Rev. Proc. 2014-4, 2014-1 IRB, §6.02(4). Note, this procedure is updated by the IRS annually. The updated procedure will always have the first four digits the same as the year of issuance, and the suffix will always be "-4."
[87] ERISA §204(h)(6)(A).
[88] Treas. Reg. §54.4980F-1, Q&A-14(c).

- The failure was to provide notice to most of the applicable individuals with most of the information they were entitled to receive; *or*
- The failure is otherwise determined to be egregious under Treasury regulations.[89]

If there is an egregious failure, all applicable individuals receive the greater benefit, as described above, even if the egregious failure has occurred with respect to only certain applicable individuals. In an example in the regulations, an employer intentionally fails to provide timely ERISA §204(h) notice to only certain applicable individuals. The ERISA §204(h) amendment was effective January 1, but the intentional failure with respect to these certain individuals resulted in delivery of the ERISA §204(h) notice on May 16 of that year. Because an intentional failure is egregious, the amendment is not considered effective until the May 16 delinquent date with respect to all participants and alternate payees. Thus, for the period January 1 through May 16, the greater of the two calculations applies.[90]

Consequence of Nonegregious Failure

If the failure is not egregious, the ERISA §204(h) amendment still goes into effect and just the excise taxes under IRC §4980F apply. However, the regulation notes that an applicable individual who did not receive notice may have recourse under ERISA §502 (e.g., claim for benefit), even though such failure was not egregious.[91]

Manner of Giving the ERISA §204(h) Notice

The method used to provide notice must be reasonably calculated to result in actual notice.[92] This includes:

- Hand delivery;
- US mail to the last known address of the applicable individual; and
- Electronic delivery (e.g., email, company website).

Posting the notice (e.g., on a bulletin board in the employee cafeteria) is not an acceptable delivery method.

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Date of Receipt of the ERISA §204(h) Notice

Normally the date the notice is actually delivered to the applicable individual is the date it is actually received. However, notice mailed by first class mail is considered provided as of the date of the US postmark stamped on the document.

Receipt by Electronic Delivery

For electronic delivery, the date of delivery depends on whether access to the delivery method is an integral part of a participant's duties. Two examples in the regulations illustrate this. In one example, the ERISA §204(h) notice was sent by email on July 1, but it was not an integral part of the participant's duties to access the company's electronic information system on a daily basis. In this example, delivery did not actually occur until July 9, when the company received notification indicating that the email was received and opened, pursuant to a computer-generated notification requested at the time the email was sent. In the second example, the notice was sent via email on August 1, but an integral part of the employee's duties was to access the company's electronically-generated documents and the employee had effective access to such documents. In this example, delivery was deemed received on August 1 (i.e., the date the email was sent), regardless of the date the employee actually opened it.[93]

[89] ERISA §204(h)(6)(B).
[90] Treas. Reg. §54.4980F-1, Q&A-14(a)(3).
[91] Treas. Reg. §54.4980F-1, Q&A-14(b).
[92] Treas. Reg. §54.4980F-1, Q&A-13.
[93] Treas. Reg. §54.4980F-1, Q&A-13(c)(2).

Conditions on use of electronic delivery method. The regulations outline additional requirements for use of electronic delivery of the ERISA §204(h) notice.[94] These conditions parallel the DOL's requirements for furnishing Title I documents via electronic media.[95] The individual must receive a clear and conspicuous statement (electronic or nonelectronic) that informs the individual of a right to request and obtain a paper version of the notice without charge. Delivery must occur no later than the deadline for providing the notice and must satisfy the content requirements. If it is not otherwise reasonably evident, the recipient of the notice must be apprised (in electronic or nonelectronic form), at the time the notice is furnished electronically, of the significance of the notice. For example, a warning of the significance in the subject line of an email might be sufficient to meet this requirement. Also, there must be evidence of actual delivery or at least that appropriate and necessary measures have been taken that are reasonably calculated to ensure the method of delivery results in actual delivery. A safe harbor rule deems this requirement to be satisfied if certain procedures are met, including the obtaining of affirmative consent (confirmed electronically) by the individual to receive the notice electronically.[96]

Application of Notice Requirement to Amendments or Mergers Occurring Because of the Sale of a Business

The need for an ERISA §204(h) notice in connection with the sale of a business depends on whether an ERISA §204(h) amendment is adopted with respect to the seller's plan.[97] If the sale causes the employees not to be covered under the seller's plan (for example, in an asset sale where the seller retains the plan), there is no amendment, so no ERISA §204(h) notice is required. On the other hand, if the seller's plan would continue to cover the employees (such as, when stock is sold and the sold company becomes a subsidiary of the buyer), but an amendment is adopted to freeze or terminate the plan, a notice would be needed. The important issue, therefore, is whether there is an amendment to the plan that constitutes an ERISA §204(h) amendment.[98]

Section 10.04: Plan Terminations

There are times when the employer wants to terminate the plan. Reasons why this could happen include:

- The employer's goals and objectives have changed;
- The plan has not been effective in achieving the employer's goals and objectives;
- Maintaining the plan has become too expensive, often because the employer's financial condition has changed;
- There has been a significant change in employee demographics that causes the plan to be ineffective;
- New plan designs have become available that make the old plan obsolete;
- Congressional legislation has caused the plan design to be unlawful; or
- The company itself is winding down or being sold.

Plan documents generally permit the employer to terminate the plan at its discretion (although defined benefit plans that are subject to the PBGC may be required to comply with certain requirements to terminate). This section will discuss the procedures involved in terminating a defined contribution plan.

[94] Q&A-13(c) of Treas. Reg. §54.4980F-1.
[95] See DOL Reg. §2520.104b-1(c).
[96] Treas. Reg. §54.4980F-1, Q&A-13(c)(3).
[97] Treas. Reg. §54.4980F-1, Q&A-16(a).
[98] Treas. Reg. §54.4980F-1, Q&A-16(b).

FROZEN PLANS

The IRS has defined a plan termination as when the plan is being ceased and benefits will be distributed as soon as administratively feasible. If the intent is to have the benefits remain in the plan until a normal distributable event occurs, the plan will be considered to be frozen, rather than terminated.[99] Therefore, freezing a plan is a good alternative to termination when the employer does not want to distribute benefits.

If a plan is amended to be a **frozen plan**, no additional benefits are earned, but the benefits are not distributed until a normal distribution event occurs. In all other respects, the frozen plan is active, requiring it to file all annual reports with the government and the participants and to keep up with amendments required by changes in the law.[100]

PARTIAL PLAN TERMINATIONS

A partial plan termination causes the affected participants to become 100 percent vested in their funded benefits.[101] The IRC does not specifically define what constitutes a **partial plan termination**. Generally, it occurs when a significant reduction in the number of participants occurs, either by plan amendment or by involuntary termination of employment. A plan amendment that affects the right to vest in benefits may also cause a partial termination. The IRS will examine the facts and circumstances of a particular event to determine whether a partial termination has occurred.[102] The IRS will often look at multiple events of the employer as a sole event when examining the facts and circumstances.

The **affected participants** who receive the 100 percent vesting are those who are eliminated from participation through a significant reduction or by a plan amendment that resulted in the partial termination. Participants who are not affected by the amendment or who continue to be covered by the plan remain subject to the vesting schedule with respect to their benefits.

Significant Reduction

When a group of participants is involuntarily eliminated from the plan, a partial termination occurs if the reduction in participants is significant. The IRS has focused on the percentage of participants, not the number, eliminated from the plan to determine if the reduction is significant. The IRS defines significant to be at least 20 percent of the participants.[103] If the reduction is less than 40 percent, but at least 20 percent, the IRS may be willing to consider mitigating facts and circumstances. However, it is recommended that an employer seek a determination letter on the partial termination (using Form 5300) if it is unwilling to accelerate vesting after a reduction involving at least 20 percent of the participants.

Because the concept of a partial termination is so vaguely defined and so dependent on facts and circumstances, it has been an area of heavy litigation. This litigation has examined such issues as the time period over which the terminations of employees has taken place, whether the terminations are incident to some determinable corporate event, what group of employees is examined in determining the 20 percent decrease (i.e., are only partially vested participants included in the determination, or do fully vested participants count, too?), and the effect of voluntary employee terminations in anticipation of a corporate event, as opposed to layoffs or firings by the employer.

Cessation of Contributions or Freezing of Benefits in a Profit Sharing or Stock Bonus Plan

A profit sharing or stock bonus plan must have recurring and substantial contributions to be a qualified plan.[104] If amounts contributed are not sufficiently significant to reflect intent to continue the plan, the IRS will treat the contri-

[99] Rev. Rul. 89-87, 1989-2 C.B. 81.
[100] Notice 87-57, 1987-2 C.B. 368.
[101] IRC §411(d)(3).
[102] Treas. Reg. §1.411(d)-2(b)(1).
[103] Announcement 94-101, 1994-25 I.R.B.; IRS Manual at §7.12.1.2.7.3. See also Rev. Rul. 2007-43,IRB 2007-48, Rev. Rul. 81-27, 1981-1 C.B. 228; Rev. Rul. 73-284, 1973-2 C.B. 139; Rev. Rul. 42-439, 1972-2 C.B. 23.
[104] Treas. Reg. §1.411(d)-2(d).

butions as discontinued. If there is a complete discontinuance of contributions to a profit sharing or stock bonus plan, the affected participants must be 100 percent vested.[105]

A temporary suspension of contributions generally does not lead to full vesting. For example, a lack of profits is considered to be reasonable circumstances for suspending contributions, even if profits are not required for contributing to the profit sharing plan.[106] Other factors the IRS will consider in characterizing a suspension or a complete discontinuance of contributions include:

- Evidence of an intent to avoid full vesting;
- Lack of recurring or substantial contributions; or
- Reasonable probability that the suspension will continue indefinitely.[107]

If the IRS determines contributions were completely discontinued, the discontinuance will become effective no later than the last day of the employer's tax year following the tax year in which the employer last made a substantial contribution.[108] In its audit guidelines,[109] the IRS states that an issue of discontinuance arises when the employer has failed to make substantial contributions for at least three years in a five-year period. In such case, the IRS typically will presume a complete discontinuance has occurred, and shift the burden to the employer to present evidence that a complete discontinuance has not occurred.

If an employer discontinues making nonelective contributions to a 401(k) plan, but continues the 401(k) arrangement, will the contributions be considered to be discontinued? The IRS has not formally ruled on this issue, but presumably, the answer is no. Elective contributions are considered to be employer contributions under IRC §402(c)(3), and the 401(k) arrangement is part of the profit sharing or stock bonus plan.[110]

Conversion of Plan Into Another Type of Plan

If a defined contribution plan is amended into another type of defined contribution plan (e.g., a money purchase plan into a profit sharing plan), this generally does not cause a partial plan termination to occur and does not require the affected employees to be fully vested.[111]

Freezing of Defined Contribution Pension Plan

A money purchase or target benefit plan is not subject to the same obligations as a profit sharing plan or a stock bonus plan to have recurring and substantial contributions to the plan. The IRS has indicated that the freezing of a money purchase or target benefit plan is tantamount to amending the contribution formula to zero percent of compensation, and does not require accelerated vesting.[112]

EFFECT OF PLAN TERMINATION

When a plan termination occurs, there are two important effects on the plan and its participants. First, all participants become fully vested in their benefits.[113] Second, the plan must distribute all benefits within a reasonable time.[114] If this

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[105] Rev. Rul. 89-53, 1989-1 C.B. 116.
[106] Rev. Rul. 80-146, 1980-1 C.B. 90.
[107] Treas. Reg. §1.411(d)-2(d)(1).
[108] Treas. Reg. §1.411(d)-2(d)(2).
[109] Announcement 94-101.
[110] See IRS Q&A Session at the October 2003 ASPPA Annual Conference in Washington, D.C., Q&A-22, in response to which the IRS stated that the elimination of matching and profit sharing contributions under a 401(k) plan did not trigger full vesting because the contribution of elective deferrals under the 401(k) arrangement is a continuation of employer contributions.
[111] Rev. Rul. 2002-42.
[112] Rev. Rul. 2002-42.
[113] IRC §411(d)(3).
[114] Rev. Rul. 89-87, IRB 1989-27.

distribution does not occur, the plan will be deemed to be frozen, rather than terminated.

PLAN TERMINATION PROCEDURES

Establishing the Termination Date

The employer must establish the effective date of the plan termination. In general, for a defined contribution plan termination, a facts-and-circumstances analysis determines whether the plan has terminated and when.[115]

Most plan documents outline the steps that must be taken to establish the termination date of the plan. In general, it takes an action by the governing body of the plan sponsor to terminate the plan.

Board Resolution

If the employer is a corporation, the usual method of effecting a plan termination is through a resolution of the Board of Directors. This may occur either at a general or special meeting of the Board or through unanimous written consent of the directors.

If the employer is not a corporation, a formal resolution establishing the termination date should be executed by the owner or owners of the business entity. It is important to know what it takes to have a valid action by the entity under consideration. Many partnerships can take binding action by having any partner (or, in the case of a limited partnership, any general partner) sign a resolution. However, some partnerships have other requirements stated in their partnership agreement that would prevent such a significant action as a plan termination from taking place without a larger consensus of the partners. In limited liability companies or partnerships, the organization documents will outline what must occur for effective action to take place.

Notice to Employees

ERISA §204(h)

As discussed earlier in this chapter, advance notice to employees of the significant reduction in the future rate of benefit accrual is required for pension plans only (i.e., money purchase plans and target benefit plans, as well as defined benefit plans).

Notice of Intent to Terminate (PBGC)

Defined benefit plans covered by the PBGC must provide a Notice of Intent to Terminate to the participants. The Notice must be provided at least 60 days but no more than 90 days before the proposed plan termination date.[116] This Notice may be issued in conjunction with the ERISA §204(h) notice.

Nonpension Plan

No advance notice is required to employees in a nonpension plan [i.e., profit sharing plan, stock bonus plan, 401(k) plan] that is terminating. Nonetheless, it is generally advisable for an employer to let the employees know that the plan is terminating.

If the plan is a 401(k) plan, the employer should notify employees that the plan has been terminated and no elective contributions will be withheld from subsequent paychecks.

[115] *Gant v. Commissioner*, 76 T.C.M. 994 (1998).

[116] ERISA Reg. §4041.23(a)(1).

Permanency

If a plan was established less than ten years prior to its termination, consider whether there is a permanency issue. The IRC requires that a plan be intended at its inception to be permanent.[117] When a plan terminates in the early years of its existence, it calls into question whether the plan was actually intended to be permanent. If determined that permanency was not intended, the plan may be disqualified retroactively to when it was originally effective.

Nonpension Plans

For nonpension plans, permanency is generally not an issue if the plan has been in existence at least two years. This two-year consideration reflects the distribution rule that says that nonpension plans may permit distribution of employer contributions after they have been held in the trust at least two years. Note, however, that there are special distribution restrictions for elective contributions in a 401(k) plan that may be at issue.

Pension Plans

For pension plans, there should be a legitimate business reason for terminating within ten years, although the IRS seems to address this issue more often when the plan is a defined benefit plan. A legitimate business reason includes the following:

- Business restructuring, such as merger, change in stock ownership or bankruptcy reorganization;
- Change in law affecting qualified plans;
- Substitution of another plan; or
- Financial hardship.

Plan Amendments

In addition to a resolution to terminate the plan, some companies will adopt a termination amendment. This amendment will accomplish several things. First, it will clearly put an end to all new benefits, accruals, or contributions (except those that are for periods of time prior to the plan termination but are not yet deposited) and to new participants entering the plan and earning benefits. Second, it will modify the plan's vesting schedule to provide for the 100 percent vesting. This may not be necessary if the plan document clearly provides for full vesting on termination (which it likely will). Finally, it may modify distribution options to make lump-sum distributions available or to narrow the options on plan termination as permitted under the anti-cutback rules.

Law Changes

Have any law changes affecting plan qualification taken effect since the plan was last amended? If yes, the plan sponsor must adopt all necessary amendments, even if the amendment would not actually affect the computation of accrued benefits under the terminated plan. IRS Notice 87-57 provides that the remedial amendment period for any law changes in effect as of the termination of the plan is accelerated when the plan terminates. In other words, the employer may not terminate and distribute the plan and then wait until the otherwise scheduled remedial amendment period deadline to adopt the necessary plan amendments. Some new law provisions are optional so that amendments in relation to those provisions would be necessary only if, as of the termination date, the employer had elected to apply such provision, but the plan had not been amended yet to reflect the plan's operational compliance with such provision.

The termination-related amendment must address only provisions that have become effective in the plan year in which the plan termination date occurs or earlier. Provisions that become effective in a later year are not required to be adopted, even if final distribution of assets occurs in such later year. This makes the timely distribution of assets important. As noted above, if the assets are not distributed on a timely basis, the IRS may deem the plan to be merely frozen and

[117] Treas. Reg. §1.401-1(b)(2).

not terminated. Frozen plans are required to stay up-to-date with legal changes. Therefore, if a plan is terminated and the IRS determines that untimely distributions have caused the termination to be a freeze instead, it is possible that the plan will not have been kept up-to-date with all legal changes after the originally intended termination date. This may cause the plan to fail to satisfy the qualification requirements.

Amendments Needed Due to IRS Rulings or Notices

From time to time, the IRS will publish a new position (usually in the form of a ruling or notice) that affects qualified plan documents. Recently, the IRS has begun accompanying these pronouncements with model amendments. It is possible that in the plan year in which a plan terminates (or in a previous year for which the amendment requirement is still open), the plan operated in a manner that requires an amendment on account of such a pronouncement, or the plan terminates before a mandatory deadline to comply with an amendment requirement has passed.

Cumulative List of Changes

The IRS publishes a list each year (generally in November) of the changes in the qualification requirements of the IRC as well as those items of published guidance relating to the plan qualification requirements, such as regulations and revenue rulings, that are expected to be incorporated in any plan that is up-to-date that year.[118] This is particularly provided for individually designed plans that must obtain new favorable determination letters for the following year, as well as terminated plans that must be updated, as it constitutes the items that the IRS requires be addressed in the determination letter review.

Filings With Governmental Agencies

Determination Letter Request to IRS

Filing for a determination letter with the IRS is not required by law to maintain qualified status, but is recommended. This filing, which takes place on a Form 5310, will obtain a ruling from the IRS that the termination of the plan does not negatively affect its qualified status.

If You're Curious . . .

Failure to apply for a determination letter may increase chances for audit.[119] Some practitioners believe that applying for a determination letter to the IRS is tantamount to volunteering for a plan audit. This belief is based on two factors. First, the IRS's review of a plan on termination is fairly extensive, therefore appearing somewhat like a plan audit. Second, some practitioners have noticed an increase of audit activity by the IRS over the years in connection with plans that *do* get a favorable determination letter.

The best reason to obtain a favorable determination letter on plan termination has to do with the plan documentation. With legislation relating to retirement plans in continuous flux, and with remedial amendment periods extending for significant periods of time, it is very difficult to know for sure that the plan document satisfies all the IRS's form requirements without an IRS favorable determination. As mentioned above, there may be myriad good faith amendments and interim amendments that should be adopted, and it is easy to miss those. By applying to the IRS for a favorable determination letter, the remedial amendment period for these amendments is extended to 91 days after the determination letter is received, and the letter confirms that the plan is qualified as of the IRS's review.

Filing as soon as possible with the IRS will ensure that distributions may be delayed until the favor-

[118] Rev. Proc. 2005-66, 2005-37 I.R.B. 509, §4. See Notice 2013-84 for most recent Cumulative List of Changes.
[119] See IRS Announcement 93-9, which provides examination guidelines for audits of plans that have terminated without a favorable determination letter.

able determination letter is received. Otherwise, if too much time expires between the termination of the plan and the distribution of assets (even if much of that time is related to the application and process of getting a favorable determination letter) the plan may be considered to be merely frozen and not terminated.

Another good reason to apply for a determination letter on plan termination is if there is the potential for a problem with the permanency rule. If there is a doubt that the IRS will find the plan to have been permanent, a ruling on this issue is helpful. Furthermore, if there is concern, the plan termination amendment may be made contingent on a finding by the IRS that the plan was permanent. In that way, if the IRS finds that the plan is terminating too soon, it may continue operating until permanency is no longer a factor.

If the plan document is an pre-approved plan, the opinion letter provides reliance on qualification only during the active maintenance of the plan. These letters do not provide reliance on qualification upon plan termination.

Notice to Interested Parties

If a determination letter is requested, an interested party notice is required to all present employees with accrued benefits, former employees with vested benefits still in the plan, alternate payees under QDROs and beneficiaries of deceased participants who have benefits payable under the plan.

Distributing Plan Assets

Calculating Benefits

The benefits to be distributed must be determined. This will involve making final allocations of employer contributions and forfeitures. If the plan is a pension plan, the employer must determine if any additional funding is required as part of the termination process.

If the plan is a money purchase or target benefit plan, the employer must determine whether the plan has a last-day requirement for receipt of a contribution. If it does, and if the plan termination is effective on other than the last day of the plan year, the employer must decide whether the plan should be amended so that the date of termination is considered to be the last day for purposes of this rule. Alternatively, the employer may be purposely terminating the plan before year end to ensure that no funding is required in the year of termination.

If the terminating plan is a 401(k) plan, the employer must transmit and allocate any elective contributions withheld before the termination date that have not been deposited to the plan. If applicable, matching contributions required on contributions made before the termination date must be deposited and allocated.

If You're Curious . . .

Vesting of Benefits

Full vesting is required when a plan terminates. This requirement affects only current employees and former employees who have not forfeited nonvested benefits before the plan termination date.

IRC §415 Limits

The final determination of benefits and the allocation of contributions and forfeitures cannot violate IRC §415 limits. If the plan has unallocated forfeitures or excess annual additions, those amounts

must be reallocated to the participants in a manner that will not exceed IRC §415.[120]

Top-Heavy Rules

Top-heavy minimums are not required after the plan termination date, but any minimum contribution liabilities that accrued as of the termination date—but have not been funded—must be satisfied.[121] Note that the final allocations discussed above may create an obligation to fund a top-heavy minimum amount for the non-key employees in the year of termination.

Reducing Assets to Cash

The terminated plan will generally liquidate its investments to prepare for distributions (or direct rollovers).

If a plan permits in-kind distributions, it may be possible to distribute noncash assets as part of the plan termination. If the participants' accounts in a defined contribution plan are participant-directed, a direct rollover of a participant's benefit to an IRA or to another qualified plan might be made without liquidating the investments held by the participant's account.

Illiquid assets. If the plan holds illiquid assets, the determination must be made whether it is possible to distribute these assets in-kind to the participants. When that is not possible (for example, when the illiquid assets cannot be divided so that the appropriate share goes to each participant), the IRS has permitted the use of liquidating trusts or partnerships[122] to enable the distribution of illiquid assets. Under a liquidating trust or partnership, the participants receive participation certificates in the liquidating trust (or partnership interests in the liquidating partnership). The liquidating trust or liquidating partnership receives the distribution of the illiquid assets from the plan. From the plan's standpoint, the asset has been distributed, and the termination can be completed. From the participants' standpoint, their distributions consist partly of these participation certificates or partnership interests, which are taxable as in-kind distributions unless they are rolled over to an IRA or another qualified plan.

Distribution Process

Normal distribution procedures apply to the final distribution of assets from the plan. Participants must be provided with appropriate notice of their distribution options and their ability to roll over their funds to another qualified plan or an IRA. If the plan contains QJSA requirements, the proper waivers and spousal consent must be obtained.

Final Form 5500 Series

The final Form 5500 is filed for the year in which the assets have been completely distributed. In the interim, between the plan termination effective date and the final distribution of assets, regular filings must continue.

The date of the final distribution ends the reporting year. Therefore, the due date of the final form is generally the last day of the seventh month following the month in which the final distribution occurs (unless an extension is granted).

IRC §411(d)(6) Issues on Plan Termination

As a general rule, protected optional forms of benefit, early retirement benefits and retirement-type subsidies may not

[120] Rev. Rul. 2002-42.
[121] Treas. Reg. §1.416-1, T-4.
[122] PLR 9507032, PLR 9421041.

be eliminated merely because of the termination of the plan.[123]

In addition to the general rules permitting elimination of optional forms of benefit in defined contribution plans, special regulation provisions permit certain terminated nonpension plans [i.e., profit sharing plans and stock bonus plans, including 401(k) plans] to eliminate all optional forms of benefit other than a single-sum distribution method if certain conditions are satisfied. To qualify for this exception, the plan may not have annuity payment options. Thus, the plan cannot be subject to the QJSA requirements under IRC §417. In addition, the employer may not maintain another defined contribution plan (except for an ESOP). This coordinates with the exception from the consent requirements under IRC §411(a)(11).[124] This exception allows an eligible terminated profit sharing plan or stock bonus plan to force out single-sum distributions of all vested accrued benefits, regardless of the dollar amount of the distribution.

This exception does not override the requirement in IRC §401(a)(31) for providing an opportunity to elect a direct rollover of the vested benefit to an eligible recipient plan.

EXAMPLE 10-25. Elimination of Alternative Forms of Benefit. A profit sharing plan provides employees whose vested account balance exceeds $5,000 with the option to receive distribution in one of two forms: (1) single-sum distribution, or (2) installment distributions over a specified period of years not exceeding 25. The plan is amended, pursuant to its termination, to eliminate the installment distribution option. Consequently, not only must all plan termination distributions be made in a single-sum (which may include a direct rollover to another plan or IRA), but distributions maybe made without a participant's consent, even if the amount being distributed exceeds $5,000. The employer does not maintain any other defined contribution plan. This amendment does not violate IRC §411(d)(6)(B).

If You're Curious . . .

Suspension of Otherwise Available Distributions Following Plan Termination, Pending Receipt of IRS Favorable Determination Letter

As noted above, the sponsor of a terminating plan might apply for a favorable determination letter (Form 5310) from the IRS as to whether the termination adversely affects the plan's qualification. In some cases, the employer decides (or is advised) to suspend all distributions from the plan, even those that would otherwise be available to participants in the absence of a termination of the plan. Does such a suspension violate the protected benefit rules under IRC §411(d)(6)? Neither the Treasury nor the IRS has issued any guidance on this subject. Taking into account the general protections offered by IRC §411(d)(6), it is likely that the law does not support the suspension of all distributions in this case, unless special circumstances exist that make it reasonable to delay distributions (e.g., pending litigation against the plan that might affect the final value of distributions).

Section 10.05: Review of Key Concepts

- What is a plan amendment?
- Describe situations where a plan may be amended to correct discrimination issues.
- When must a corrective amendment be adopted?
- What is an SMM and when it is required?
- What is the remedial amendment period?
- Describe an ERISA §204(h) amendment.

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[123] Rev. Rul. 85-6, and S. Rep. No. 98-575, 98th Cong., 2nd Sess. 31 (1984).

[124] Treas. Reg. §1.411(a)-11(e).

- What is the purpose of an ERISA §204(h) notice?
- When and to whom must an ERISA §204(h) notice be distributed?
- What happens when a plan is terminated?
- Describe the steps, including securing a determination letter, for a defined contribution plan that is terminating.
- Name several benefits, rights, or features that are considered IRC §411(d)(6) protected benefits.
- What are the anti-cutback rules?

Section 10.06: For Practice – True or False

1. Participants become 100 percent vested if a profit sharing plan completely discontinues contributions.
2. An ERISA §204(h) notice must be provided to participants when a profit sharing plan terminates.
3. Optional forms of benefits include any option related to the form or timing of distribution under the plan.
4. Form 5500 filings are not required once a plan is frozen.
5. A plan must apply for a letter of determination upon plan termination.
6. The anti-cutback rule under IRC §411(d)(6) protects certain benefits from being eliminated by plan amendment.
7. Plan amendments must be in writing.
8. For anti-cutback purposes, a plan benefit is considered accrued when a participant has met the allocation conditions necessary for such benefit.
9. The plan may eliminate hardship withdrawal provisions without violating anti-cutback rules.
10. A plan may be amended only prospectively for current legislative requirements during the remedial amendment period.

Section 10.07: Sample Test Questions

1. All of the following statements regarding plan changes are TRUE, EXCEPT:
   A. A money purchase pension plan must distribute an ERISA §204(h) notice if its accrual formula is being amended from 10 percent of compensation to 5 percent of compensation.
   B. A plan document must be in compliance with current legislation before it can be properly terminated.
   C. A profit sharing plan must provide for 100 percent vesting to affected participants upon plan termination.
   D. A 401(k) plan must distribute an ERISA §204(h) notice if it is eliminating a fixed matching formula.
   E. A money purchase pension plan may amend the contribution formula to zero percent of compensation.
2. All of the following statements regarding plan amendments are TRUE, EXCEPT:
   A. The timing of a plan amendment must not discriminate significantly in favor of HCEs.
   B. A voluntary plan amendment must be adopted by the end of the plan year affected.
   C. With limited exception, a plan may not be amended to reduce an accrued benefit.
   D. A QJSA option may be eliminated in a profit sharing plan.
   E. A corrective amendment may not eliminate a benefit, right or feature.

3. All of the following must occur for a proper plan termination, EXCEPT:
   A. Establish a plan termination date
   B. Notice to participants in a pension plan

C. Form 5310 filing
D. Distributing plan assets
E. Final Form 5500 filing

4. All of the following are optional forms of benefit under IRC §411(d)(6), EXCEPT:
   A. Distribution in the form of an annuity
   B. Ability to direct investments
   C. Distribution timing following separation of service
   D. Ability to take a hardship withdrawal
   E. Ability to take an in-service distribution

5. Which of the following statements regarding corrective amendments is/are TRUE?
   I. A corrective amendment may not reduce accrued benefits for NHCEs.
   II. A corrective amendment may reduce accrued benefits for HCEs.
   III. Additional allocations resulting from a corrective amendment need not satisfy IRC §401(a)(4) nondiscrimination requirements when tested separately.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

6. Which of the following statements regarding the remedial amendment period is/are TRUE?
   I. The plan document, as written, may fail to comply with current law during a remedial amendment period if it is corrected within such period.
   II. Amendments made in the remedial amendment period to conform to that law may be made retroactively.
   III. If an amendment is submitted to the IRS within the remedial amendment period, the period is extended until the 91st day following the receipt of the favorable determination letter from the IRS.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

7. All of the following statements regarding protected benefits under IRC §411(d)(6), are TRUE, EXCEPT:
   A. The right to direct investments is not protected.
   B. The right to elect an in-service withdrawal is not protected.
   C. The right to an ancillary life insurance benefit is not protected.
   D. The right to elect a hardship withdrawal is not protected.
   E. The right to elect a participant loan is not protected.

8. Which of the following statements regarding plan terminations is/are TRUE?
   I. All plan participants must become 100 percent vested if a full plan termination occurs.
   II. All plan participants must become 100 percent vested if a partial plan termination occurs.
   III. Advance notice to employees is required to terminate a profit sharing plan.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

9. Which of the following statements regarding SMMs is/are TRUE?

I. An SMM must explain the amendment or change in a manner that can be reasonably understood by the average participant.
II. An SMM must be distributed no later than 190 days after the close of the plan year in which the amendment was adopted.
III. No SMM is required if the change is incorporated into an SPD that is delivered to participants prior to the deadline of the SMM.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

10. Which of the following plans is/are subject to the ERISA §204(h) notice requirements?

I. A nonpension plan
II. Target benefit plan
III. Money purchase plan

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

Section 10.08: Solutions to True or False Questions

1. True.
2. False. The ERISA §204(h) notice is only required for pension plans, e.g., defined benefit, money purchase pension and target benefit plans.
3. True.
4. False. Form 5500 filings are generally required until all assets are distributed. Frozen plans continue to exist until all assets are distributed.
5. False. Determination letters are recommended, but are not required.
6. True.
7. True.
8. True.
9. True.
10. False. The remedial amendment period is a period whereby the plan may be amended retroactively to conform the plan to legal requirements.

Section 10.09: Solutions to Sample Test Questions

1. The answer is **D**. Nonpension plans, such as 401(k) plans, are not subject to ERISA §204(h) notice requirements.
2. The answer is **E**. A corrective amendment may eliminate a benefit, right or feature, but the amendment must be made by the end of the plan year, not 9½ months after the end of the plan year.
3. The answer is **C**. A Form 5310 filing would be used to apply for a letter of determination upon plan termination. This is an optional filing, and although recommended, it is not required.
4. The answer is **B**. An optional form of benefit is any option that relates to the form or timing of distribution under the plan. The ability to direct investments is not an optional form of benefit.
5. The answer is **A**. A corrective amendment may not reduce accrued benefits, regardless of the employees' status as NHCEs or HCEs. Any additional allocation or benefit accrual resulting from the corrective amendment generally must be able to satisfy IRC §401(a)(4) when tested separately.
6. The answer is **E**. All of the statements are true.
7. The answer is **B**. The right to elect an in-service withdrawal is a protected optional form of benefit.
8. The answer is **A**. A partial plan termination causes only the affected participants to become 100 percent vested in their funded benefits. No advance notice is required to employees in a nonpension plan that is terminating.
9. The answer is **C**. An SMM must be distributed no later than 210 days after the close of the plan year in which the amendment was adopted.
10. The answer is **D**. Only pension plans are subject to ERISA §204(h) notice requirements.

Chapter 11:
Annual Reporting Requirements

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Section 11.01: Key Terms

- Audit requirement
- Common/collective investment trust (CCT)
- Delinquent Filer Voluntary Compliance Program (DFVC Program)
- Direct filing entity (DFE)
- Employee
- Employee benefit plan
- Employee Benefits Security Administration (EBSA)
- ERISA Filing Acceptance System (EFAST)
- Fidelity bond
- Form 5500
- Form 5500-EZ
- Form 5500-SF
- Form 5558
- Group insurance arrangement (GIA)
- Large plan filer
- Master trust investment account (MTIA)
- Nonelecting church plan
- Participant
- Pooled separate accounts (PSA)
- Qualifying plan assets
- Small plan filer
- Summary annual report (SAR)
- SOC 1 report

Section 11.02: Introduction

Much of what we have discussed in this book so far relates to the Internal Revenue Code (IRC) and Treasury requirements for qualified plans. However, as we outlined in Chapter 1, ERISA has four titles, and Title I outlines the requirements that are enforced by the Department of Labor (DOL). This Title is often referred to casually as ERISA, even though it is only a part of ERISA, and even though the changes to the IRC are also part of ERISA (in Title II).

Just as the Treasury Department and the IRS publish guidance on the tax-related sections of ERISA through Treasury Regulations, IRS Revenue Rulings, IRS Revenue Procedures, IRS Notices and Private Letter rulings, the DOL and its benefit agency, the **Employee Benefits Security Administration** (EBSA) also issue guidance. The Labor guidance is made up of: DOL regulations, DOL Field Assistance Bulletins, DOL Opinion letters and Prohibited Transaction Exemptions.

One of the most significant portions of Title I of ERISA is the reporting and disclosure requirements. This section of the law requires administrators to report plan and benefit information to government agencies and participants. Subsequent tax regulations broadened the reporting requirements. Severe penalties may be imposed if plan administrators do not comply with the various reporting requirements.

This chapter will discuss the various reporting and disclosure requirements with which plan sponsors and fiduciaries must comply.

Section 11.03: Which Plans are Subject to Title I of ERISA?

Title I of ERISA was enacted to protect the rights of employees under employee benefit plans. The first consideration in regard to ERISA coverage, therefore, is whether the plan is an employee benefit plan. An employee benefit plan may fall into one of two categories: pension plan or welfare plan. The Title I requirements in many respects apply differently to pension plans than to welfare plans. Qualified plans, that are the focus of this book, fall into the category of pension plans for Title I purposes. This creates some confusion in terminology because the IRC refers to some qualified plans (defined benefit, money purchase and target benefit plans) as pension plans and other qualified plans (profit sharing plans and stock bonus plans) as nonpension plans. For Title I purposes, all of these plans are employee pension benefit plans.

EMPLOYERS SUBJECT TO TITLE I

To be an employer that is subject to Title I, a person or organization must have an employer-employee relationship with

employees covered by the plan. The Supreme Court applies common law principles to determine whether a person is acting as the employer of an employee.[1]

Exception for Governmental Plans

A governmental plan is exempt from Title I of ERISA.[2] Governmental plans are defined in ERISA §3(32). Because of its exemption from Title I, a governmental plan need not comply with the reporting requirements described in this chapter. Note, however, that governmental plans may be qualified plans under IRC §401(a) and, in that regard, the IRS would have enforcement authority over the plan's qualified status. In other words, the IRS could take action to disqualify the plan if it fails to satisfy the requirements of IRC §401(a).

Exception for Church Plans

A church plan is exempt from Title I of ERISA if it is a **nonelecting church plan** under IRC §410(d), meaning that it has not elected to be subject to the minimum eligibility and vesting standards imposed by ERISA and the IRC.[3] A church plan must be established and maintained by a church or by a convention or association of churches that is exempt from federal income tax under IRC §501.[4] A plan may be a church plan even though some participants are not employees of the church or of the convention or association of churches, provided that substantially all of the participants are church employees. A plan cannot qualify as a church plan if it is maintained primarily for the benefit of church employees who are employed in connection with one or more unrelated trades or businesses conducted by the church.[5]

CERTAIN OWNERS OF EMPLOYER NOT TREATED AS TITLE I EMPLOYEES

The term employee is used differently for Title I purposes than for IRC purposes. A qualified plan may cover owners of an unincorporated business that maintains the plan if the owner provides personal services to the business. These owners are referred to as self-employed individuals. They may be treated as employees for qualification purposes even though they are not employees in the traditional sense. A shareholder of a corporate entity that maintains the plan also may be covered by the qualified plan as an employee.

DOL's Definition of Employee

For Title I purposes, the DOL defines an employee in a more restrictive manner than the IRC, ruling that sole proprietors, partners and sole shareholders of corporations, as well as the spouses of such individuals, are not employees for purposes of determining whether a plan is an employee benefit plan.[6]

If You're Curious . . .

Sole Proprietor

A sole proprietor is a person who owns 100 percent of an unincorporated business. This type of person is what many of us think of when we hear the term self-employed individual. A sole proprietor typically reports income from the business on Schedule C of the federal income tax return. A person retained as an independent contractor would generally fall into this category, as well. Neither a sole proprietor nor his or her spouse is an employee under Title I of ERISA.[7]

[1] *Nationwide Mutual Insurance Company v. Darden*, 112 S.Ct. 1344 (1992).
[2] ERISA §4(b)(1).
[3] ERISA §4(b)(2).
[4] ERISA §3(33).
[5] ERISA §3(33)(B).
[6] DOL Reg. §2510.3-3.
[7] DOL Reg. §2510.3-3(c)(1).

Sole Shareholder of a Corporation

If a corporation has only one shareholder, the shareholder is not an employee for Title I purposes. If two people who are married to each other are the only shareholders of a corporation, neither shareholder is an employee for Title I purposes.[8]

The only family member mentioned in the regulation is a spouse. Thus, if a plan is maintained by a corporation with two or more shareholders, it is an employee benefit plan under Title I of ERISA unless the shareholders are married to each other and are the only participants. If there are two shareholders and the shareholders are not married to each other, the shareholders are employees for Title I purposes, even if the shareholders are the only participants in the plan.[9]

Partners of a Partnership

If the employer is a partnership, the partners of that partnership and spouses of the partners are not employees for Title I purposes.[10] Note the difference between this rule and the rule for corporations. Where there are two or more shareholders of a corporation, the shareholders are Title I employees. Partners of a partnership are not employees, no matter how many partners there are. For example, if a partnership has 50 partners, none of the 50 partners and spouses of those partners is an employee for Title I purposes.

What Does it Mean to Not Be an Employee for Title I Purposes?

If an individual is not treated as an employee under DOL regulations, do the protections of Title I apply to that individual? When a nonemployee is the only participant in the plan, the answer is no. In fact, Title I of ERISA does not apply to such a plan.

What Does it Mean if There Are No Title I Employees in the Plan?

If all of the participants in the plan are individuals who are not employees for Title I purposes, then the plan is not an employee benefit plan under Title I of ERISA.[11] As a result, requirements that apply only to Title I-covered plans, such as the need to provide an SPD to participants, would not apply to the plan. Also, the fiduciary standards of Title I would not apply to fiduciaries of the plan. Remember, however, that the IRC imposes some requirements for qualification purposes that are similar to those in Title I of ERISA. Those would continue to apply, even if the Title I rules do not. For example, certain reporting requirements mandated by the IRS will apply to a plan that is not subject to Title I.

Plans with Both Title I Employees and Nonemployees

The Supreme Court has construed the definition of employee in the DOL regulations as applicable only to the determination of whether a plan is an employee benefit plan for Title I of ERISA purposes.[12] If the plan covers at least one Title I employee, the plan is an employee benefit plan under ERISA. Once a plan is established to be an employee benefit plan under ERISA, then the plan as a whole is subject to ERISA and the ERISA provisions that apply to such plan are applicable to all participants in the plan. In that situation, the working owners (and their spouses) who are not employees under the DOL definition of an employee are still participants entitled to the protections of Title I of ERISA. For example, the working owner participant is entitled to have his or her benefits excluded from the bankruptcy estate,

[8] DOL Reg. §2510.3-3(c)(1).
[9] *Leckey v. Stefano*, 26 EBC 1967 (3rd Cir. August 20, 2001).
[10] DOL Reg. §2510.3-3(c)(2).
[11] DOL Reg. §2510.3-3(b).
[12] *Yates v. Hendon*, 32 EBC 1097 (Sup. Ct. March 2, 2004), reversing Hendon v. Yates, 87 F.3d 521 (27 EBC 2430) (6th Cir. 2002).

pursuant to Bankruptcy Code §541(c)(2), which excludes ERISA-protected benefits.[13]

Section 11.04: Bonding Requirements

GENERAL BONDING REQUIREMENTS

ERISA requires that every fiduciary and every person who handles plan funds must be bonded by a **fidelity bond**.[14] A fidelity bond is one that provides protection to the plan against loss by reason of acts of fraud or dishonesty.

Funds are considered to be handled by a person for bonding purposes if that person's duties or activities are such that there is a risk that such funds could be lost in the event of fraud or dishonesty.[15] Investment advisors who do not exercise or have the right to exercise discretionary authority with regard to the assets of the plan are not considered to handle funds for this purpose and, therefore, need not be bonded.

Amount of Bond

The amount of the bond must be fixed at the beginning of each plan year with a value of at least 10 percent of the amount of funds being handled. The amount of the bond may not be less than $1,000, even if 10 percent of the amount of funds being handled would permit a smaller dollar amount, and need not be greater than $500,000, even if 10 percent of the amount of funds being handled would otherwise require a larger dollar amount.

If separate bonds are purchased to cover different persons, classes or groups of persons, the bond value must be determined based on the amount of funds handled by the persons, classes or groups of persons covered by that bond. A blanket bond may be purchased to cover all persons who handle funds.

Generally, the maximum bond that is required is $500,000, even if plan assets exceed $5 million. However, the maximum bond amount is increased for plans that hold employer securities. For those plans, the maximum bond is $1 million.[16] This increased bond amount does not apply if the only employer securities held by the plan are part of a broadly diversified fund of assets, such as mutual funds or indexed funds.

A small plan filer under the Form 5500 reporting rules must satisfy certain conditions to be exempt from the requirement that a plan must have an independent audit. One of these conditions is that the bond be sufficient to cover no less than the value of certain nonqualifying assets if less than 95 percent of the plan's assets are qualifying plan assets.[17] This rule is discussed in more detail in the section below dealing with plan audits.

If You're Curious . . .

Bond Amount for Fiduciary Handling Funds of More Than One Plan

Although the person handling funds is the one being bonded, the regulations set the bonding amount with respect to each plan separately. If a single bond will cover the assets handled under both plans, the regulations require that such bond allow for recovery by each plan in an amount at least equal to that which would be required if bonded separately.[18] As a result, if a person handles funds under two plans and each plan's assets exceed $5 million, a separate $500,000 cap would apply with respect to the assets under each plan, for a total of $1 million of bonding required with respect to such an individual.

[13] *Id.*
[14] ERISA §412.
[15] DOL Reg. §2580.412-6.
[16] ERISA §412(a), as amended by PPA §622.
[17] DOL Reg. §2520.104-46(b)(1) and (d).
[18] DOL Reg. §2580.412-16(c).

Who Must Purchase the Bond?

The DOL permits the plan to purchase the bond with plan assets because the bond protects the plan, does not benefit any plan official and does not relieve any plan official of any obligation to the plan.[19]

Scope and Form of Bond

The bond must provide protection to the plan against loss by reason of acts of fraud or dishonesty.[20] "Fraud or dishonesty" is deemed to encompass all the risks of loss that might arise through dishonest or fraudulent acts in handling funds.[21] Thus, the bond must provide recovery for loss occasioned by such acts even though no personal gain accrues to the person committing the act, and the act is not subject to punishment as a crime or misdemeanor.[22] The bond must name the plan as an insured, the bond may not include a deductible or similar feature and the bonding company must be on the Treasury Department's Circular 570 list of approved surety companies. This list is available at http://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570_a-z.htm.

If You're Curious . . .

The bond may be an individual bond, a schedule bond or a blanket bond. An individual bond covers a named individual. A schedule bond covers a number of named individuals or each of the occupants of positions listed in the schedule. A blanket bond covers all of the insured's officers and employees with no schedule. A blanket bond may include an agent's rider, which covers acts by other persons to whom covered functions are delegated, such as administrators or other service providers. Alternatively, these agents could be listed in an individual or schedule bond.[23]

Bond Must Protect the Plan

The bond must protect the funds of the plan or plans involved. The naming of the plan or plans as insureds will provide for such recovery. If it is not clear under the terms of the bond, a rider must be attached or a separate agreement must be made with the surety company to ensure that any reimbursement collection under the bond will be for the benefit of the plan or plans intended to be covered. A rider or agreement is always required if the employer or union is the first named joint insured with one or more plans, or if two or more plans are named as joint insureds under a single bond with the first named acting for all insureds.[24]

EXCEPTIONS TO BONDING REQUIREMENTS

Exemption for Certain Financial Institutions

The fiduciary need not be bonded if it:

a. Is a US corporation;
b. Is authorized to exercise trust powers or conduct an insurance business;
c. Is subject to supervision or examination by federal or state authority; and
d. Has combined capital and surplus in excess of $1 million.

If the fiduciary is a bank or other financial institution that is authorized to exercise trust powers and its deposits are

[19] DOL Interpretive Bulletin 75-5, FR-9.
[20] DOL Reg. §2580.412-7.
[21] DOL Reg. §2580.412-6.
[22] DOL Reg. §2580.412-9.
[23] DOL Reg. §2580.412-10.
[24] DOL Reg. §2580.412-18.

not FDIC-insured, the fidelity bond exemption is not available unless the bank or other institution meets bonding or similar requirements under state law that the DOL determines are at least equivalent to those imposed on banks by federal law. To date, the DOL has made no such determinations, so such non-FDIC insured institutions are not exempt from the bonding requirements.[25]

Exemption for Certain Broker/Dealers

Effective for plan years beginning after August 17, 2006, no bond is required of any entity that is registered as a broker or dealer under §15(b) of the 1934 Securities Exchange Act if the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization.[26]

REQUIREMENTS FOR SURETY COMPANY

The surety company that issues the bond must be a corporate surety company incorporated under the laws of the US or any State.[27] The bond may not be placed with any surety or other company, or through an agent or broker, in whose business operations the plan or any party-in-interest has significant control or financial interest (direct or indirect).[28]

Section 11.05: Reporting to the Government Agencies

ERISA establishes reporting requirements for employee benefit plans. These reporting rules provide the primary means by which the government agencies enforce the requirements of ERISA. The government agencies charged with the enforcement of ERISA are EBSA, the IRS and the PBGC. The reporting requirements that apply to each of these agencies differ, depending on the type of plan and the type of sponsor. The most well-known of the reporting requirements is the Form 5500, an annual return that is filed for most plans. Although this chapter is devoted primarily to the Title I requirements, reporting requirements that are found elsewhere, such as the IRC, are also covered.

The EBSA has published the *Reporting and Disclosure Guide for Employee Benefit Plans*, which lists the various Title I and Title IV requirements relating to reporting and disclosure. The publication is divided into three chapters: (1) the Title I disclosure requirements with respect to participants and beneficiaries; (2) the reporting and disclosure requirements for defined benefit plans under Title IV of ERISA; and (3) Form 5500 reporting requirements. This publication is available at http://www.dol.gov/ebsa/pdf/rdguide.pdf. The following link should also be used in conjunction with the Guide: https://www.irs.gov/pub/irs-tege/irs_reporting_disclosure_guide.pdf.

Section 11.06: Form 5500 – A Plan's Annual Return

Form 5500 serves as the plan's annual return to provide the government with statistical information about the plan and the plan sponsor, to report financial information about the plan and to demonstrate compliance with various legal requirements. Form 5500 is a significant enforcement tool for the DOL and IRS. Information supplied on the return is often used as the basis to identify audit targets. Because both the DOL and the IRS are receiving information via Form 5500, the form is designed to cover a broad range of plans. Not all items on the form apply to all plans for which the forms are being filed.

TYPES OF PLANS REQUIRED TO FILE FORM 5500

ERISA §103 outlines the reporting requirements for employee benefit plans, which include employee pension bene-

[25] DOL Advisory Opinion 2004-07A.
[26] ERISA §412(a)(2), as amended by PPA §611(b).
[27] DOL Reg. §2580.412-21.
[28] DOL Reg. §2580.412-22.

fit plans and employee welfare benefit plans. Pension benefit plans are subject to different requirements than welfare plans, and some of those differences are reflected in the questions asked on Form 5500. Remember that, for Form 5500 purposes, the term "pension benefit plans" includes a variety of qualified plan types including defined benefit, money purchase, target benefit, profit sharing and stock bonus plans.

The instructions to the form outline which parts of the form must be completed for different types of plans. In general, the entire form must be completed for pension benefit plans, with certain exceptions for 403(b) plans and fully-insured plans. For welfare benefit plans, only the items specifically listed in the instructions need to be completed. The reporting requirements are more comprehensive for pension benefit plans because they are subject to more requirements under ERISA.

Qualified Plans

Qualified plans are classified as employee pension benefit plans under ERISA. As an employee pension benefit plan, a qualified plan is required to be reported to the DOL under ERISA §103. A qualified plan is also required to be reported to the IRS under IRC §6058. The reporting requirement under IRC §6058 parallels the Title I requirement under ERISA §103. For that reason, the DOL and IRS jointly issue the Form 5500 series and use the same forms to satisfy both reporting requirements. Filing Form 5500 in accordance with the form's instructions satisfies the reporting obligation to both agencies.

Exemption from Title I

A qualified plan is required to be reported to the DOL only if it is covered by Title I of ERISA – that is, it must cover at least one employee. If the qualified plan is exempt from Title I, the only reporting obligation is to the IRS. This may seem unusual, as annual report filings are generally made only to the DOL and not the IRS. However, **Form 5500-EZ** is an exception to that general rule. It is filed with the IRS because it is filed only for plans that cover only owner-employees (and are not Title I plans).

Exemptions for Certain Employee Pension Benefit Plans

Certain employee pension benefit plans are not subject to the Form 5500 filing requirements.

Governmental Plans and Nonelecting Church Plans

ERISA §4 exempts these plans from the Title I reporting requirements. In Announcement 82-146, the IRS also exempts these plans from the IRC §6058 reporting requirements.

Section 403(b) Plans

In order to determine whether a section 403(b) plan is required to file Form 5500, one must first determine whether the plan is subject to Title I of ERISA.

No Form 5500 if exempt from ERISA. Section 403(b) plans are exempt from the requirement to file Form 5500 if they are not subject to Title I of ERISA. This exemption applies to plans only if:

- they are funded exclusively with the employee's salary reduction contributions; and
- the employer's involvement is limited to ministerial activities designed to make the program available to employees.[29]

Form 5500 required if Title I of ERISA applies. If the above exemption conditions are not satisfied, Form 5500 filing rules apply. At one time, 403(b) plans subject to Title I had limited Form 5500 reporting requirements, but most of

[29] DOL Reg. §2510.3-2(f).

these limits to 403(b) plan reporting obligations were eliminated for plan years beginning in 2009 and later. This change corresponds with the effective date of certain final regulations for 403(b) plans that expanded other requirements for these programs. Currently, the reporting obligations for Title I-covered 403(b) plans are substantially similar to those of qualified plans.

ERISA-covered 403(b) plans are now subject to the full annual reporting requirements, including the need to obtain an independent audit. A small 403(b) plan (i.e., fewer than 100 participants) qualifies for an audit waiver if it meets the same conditions for the audit waiver that must be met by small qualified plans. In addition, qualifying small 403(b) plans are eligible to use Form 5500-SF. Audit waivers and Form 5500-SF are discussed in detail later in this chapter.

SEPSs

SEPs are subject to reduced reporting and disclosure requirements under DOL regulations. In general, there are two types of SEPs – ones that are put into place through the adoption of a model plan provided by the IRS, and ones that do not use the model plan. The limited reporting and disclosure rules apply for SEPs that use the model document if:

- The IRS model SEP is not modified;
- All employees covered by the SEP receive a copy of the model plan; and
- Each employee receives information each year about the amount that the employer has contributed and any limitations that apply to the employee's ability to withdraw the SEP amounts.[30]

A plan that does not use the IRS model SEP form can also qualify for an exemption from Form 5500 filing, if it provides participants with a copy of the SEP document, as well as certain other disclosure items.[31]

Simple IRA Plans

SIMPLE IRA plans are exempt from the Form 5500 filing requirement.[32] This exemption does not apply to a SIMPLE 401(k) plan. A SIMPLE 401(k) plan is still an employee pension benefit plan, like any other 401(k) plan, and the annual report must be filed on behalf of the plan.

IRAs

IRAs (including Roth IRAs) are exempt from filing requirements unless they are employer-sponsored IRAs under IRC §408(c).[33]

If You're Curious . . .

Deemed IRAs

Are deemed IRAs disregarded in completing Form 5500 returns on a plan that holds deemed IRAs? The instructions to the Form 5500 do not address this issue. Because Treas. Reg. §1.408(q)-1(c) treats deemed IRAs and the qualified employer plan as separate entities, it would seem consistent with the regulatory guidance that the deemed IRA assets not be reported as part of the reporting plan's assets on Form 5500. However, the Form 5498 reporting requirements that apply to IRAs presumably would apply to deemed IRAs instead of the Form 5500 requirements.

Top Hat Plans

A top hat plan is a plan that is maintained for a select group of management or HCEs and is unfund-

[30] DOL Reg. §2520.104-48.
[31] DOL Reg. §2520.104-49.
[32] ERISA §101(g).
[33] DOL Reg. §2510.3-2(d).

ed (meaning that there is no fund set aside in which the participants have a secured or preferred interest over the general creditors of the employer).[34] For a top hat plan to be exempt from the Form 5500 filing, the employer must file a statement with the DOL, advising the DOL of the plan's existence.[35] The statement must be filed no later than 120 days after the date the plan becomes effective (or is adopted, if later). Only Title I of ERISA imposes a filing requirement on these unfunded nonqualified arrangements. The IRC does not impose filing requirements on these plans, but it does for qualified plans and other funded deferred compensation arrangements.

Excess Benefit Plans

An excess benefit plan is a type of top hat plan designed to provide benefits that are not permitted under a qualified plan because they would exceed the limits under IRC §415. Excess benefit plans are not required to file Form 5500.[36] Because the excess benefit plan is completely exempt from ERISA, the statement that is required to be filed by top hat plans is not required for excess benefit plans. The IRC does not impose any reporting requirements on these plans either.

WHICH FORM 5500 IS FILED?

The term *Form 5500* actually refers to the Form 5500 series issued annually by the IRS and DOL. There are three main forms in this series:

- Form 5500 (reporting to the DOL and the IRS);
- Form 5500-EZ (reporting to the IRS only); and
- Form 5500-SF (reporting to the DOL and the IRS), which was added for 2009 and later plan years.

Any reference in this chapter to a Form 5500 filing is intended to be a generic reference to the annual return filed on behalf of the plan, regardless of whether the filing is on Form 5500, Form 5500-SF or Form 5500-EZ, unless the context suggests otherwise.

Form 5500

This form is used for all plans unless they are eligible to use Form 5500-EZ (i.e., they are plans that cover only owners and their spouses) or Form 5500-SF (see below). The Form 5500 operates mostly as a summary of basic plan information and an identification of which schedules are to be attached.

Distinguishing characteristics of the plan determine the schedules that are attached to the form, which provide more complete information about the plan. Some schedules filed for large plans are not filed for small plans and vice versa, and some schedules filed for pension benefit plans are not filed for welfare benefit plans and vice versa. Financial information reported by a large plan is more extensive than the financial information reported by a small plan. Regulations outline the proper forms and schedules to file.[37]

Definitions of Large Plan and Small Plan

As mentioned above, the schedules attached to the Form 5500 filed by a large plan are different from the schedules attached to the Form 5500 filed by a small plan. Furthermore, as will be discussed below, all large plan filers [except 403(b) plans pre-2009], but only certain small plan filers, must retain an independent qualified public accountant to

[34] ERISA §201(2), ERISA §301(a)(3), and ERISA §401(a)(1).
[35] DOL Reg. §2520.104-23(b).
[36] ERISA §4(b)(5).
[37] See DOL Reg. §§2520.103-1, 2520.103-2, 2520.103-3, 2520.103-4, 2520.103-5, 2520.103-6, 2520.103-9, 2520.103-10, 2520.103-11, 2520.103-12.

audit the plan and include a copy of the accountant's report with their annual return. How is it determined whether a plan is a large plan or small plan filer?

As a general rule, a **large plan filer** is a plan that covers 100 or more participants at the beginning of the plan year.[38]

If a plan that has been filing the forms required for a large plan filer has its participant level drop below 100, but not below 80, it may continue to treat itself as a large plan filer. This means the plan sponsor may continue to file the schedules that apply to a large plan filer.[39] A plan is not required to use this exception and may instead follow the rules for a small plan filer, which may make the annual report less costly to prepare. Plans commonly take advantage of this exception when their participant count is expected to rise above 100 in the future, so that the audit process has continuity. It is more difficult to obtain audited financial statements in a year following a year for which no audit was performed than it is when audits have been performed each year.

As a general rule, a **small plan filer** is a plan that covers fewer than 100 participants at the beginning of the plan year.[40]

If a plan that has been filing the forms required for a small plan filer has its participant level rise above 99, but not above 120, it may continue to treat itself as a small plan filer. In that case, the plan sponsor may continue to file the schedules that apply to a small plan filer.[41] This exception to the 100-count large plan filing rules is generally referred to as the **80-120 Rule**. A plan is not required to use this exception and may instead follow the rules for a large plan filer. A plan eligible for this exception usually takes advantage of it because it means a less costly filing. So long as the participant count does not rise above 120, there is no limit on the number of years an employer may use this exception, provided that the small plan filer rules were applied in the year before. If, for any year that the participant count is above 99 but not above 120, the employer elects to be treated as a large plan filer, or if the participant count exceeds 120, then it must file as a large plan filer for all subsequent years unless the participant count drops below 100.

A plan must have at least one year with a participant count below 100 in order to take advantage of the exception referred to as the "80-120 rule" so a newly established plan with a participant count greater than 99 must file as a large plan filer.

EXAMPLE 11-1. 80-120 Rule for Small Plan Filers. A plan has 85 participants in the plan year that starts in 2011. The plan has never had more than 99 participants in prior years. The plan is a small plan filer for the 2011 plan year, meaning that the schedules applicable to a small plan were attached to the Form 5500. The following participant counts apply for the next six plan years.

Plan Year	Participant Count
2012	105
2013	118
2014	125
2015	115
2016	110
2017	119

Pursuant to the previous exception, the employer could (but did not have to) treat the plan as a small plan filer for the 2012 and 2013 plan years. However, it had to file as a small plan for the 2012 plan year to be eligible for the exception for the 2013 plan year. If the employer filed as a large plan filer for the 2012 plan year, then the exception would not apply to the 2013 plan year, and a large plan filing would be required.

For the 2014 plan year, the participant count rose above 120, so the exception to large plan filing was no longer available, even if a small plan filing was done in 2012 and 2013. Because the

[38] DOL Reg. §2510.103-1(b).
[39] DOL Reg. §2510.103-1(d).
[40] DOL Reg. §2510.103-1(c).
[41] DOL Reg. §2510.103-1(d).

exception did not apply for the 2014 plan year, the plan was not eligible for the exception for the 2015, 2016 and 2017 plan years, even though the participant count is less than 120 in those years. The plan will not again be eligible for a small plan filing unless the participant count falls below 100.

If You're Curious . . .

If an employer sponsors two or more plans, each plan determines its filing status separately, based on the participant count in that plan.[42] The DOL regulations do not provide any exception for plans that are aggregated for certain administrative purposes. For example, certain plans may be permissively aggregated to perform coverage testing, but the fact that plans are permissively aggregated for coverage testing does not affect their filing status for Form 5500 purposes.

EXAMPLE 11-2. Employer Sponsors More Than one Plan Covering Different Employee Groups. An employer sponsors two separate 401(k) plans—one for its salaried employees and one for its hourly-paid employees. The salaried plan has 45 participants at the beginning of the plan year. The hourly paid plan has 85 participants at the beginning of the plan year. The employer permissively aggregates the plans for coverage and nondiscrimination testing. Each plan is a small plan filer, because its participant count is below 100, even though the plans have a combined participant count of 130 and are aggregated for coverage and nondiscrimination testing.

Form 5500-SF

The DOL introduced the short form (**Form 5500-SF**), a two-page form, for use by certain small plan filers starting in the 2009 reporting year. An employer is eligible to use Form 5500-SF for a pension or welfare plan that meets all of the following requirements:

- The plan covers fewer than 100 participants as of the first day of the plan year, or would be eligible to file as a small plan under the 80/120 Rule, which is discussed below;
- The plan is eligible for the small plan audit waiver on the basis of its percentage of qualifying assets (i.e., the plan would not meet this requirement if it qualifies for the audit waiver because of the enhanced fidelity bonding requirements);
- The plan holds no employer securities at any time during the plan year;
- The plan has 100 percent of its assets in investments that have a readily ascertainable fair market value [e.g., mutual funds, investment contracts with insurance companies and banks valued at least annually, publicly traded securities (other than employer securities) held by a registered broker-dealer, cash and cash equivalents and/or plan loans]; and
- The plan is not a multiemployer plan.[43]

No schedules are required with Form 5500-SF, other than the appropriate Schedule SB, in the case of a single-employer defined benefit plan, or a Schedule MB, in the case of a money purchase plan or other defined contribution pension plan that is amortizing a funding waiver.

Form 5500-SF requires filers to provide basic information about the plan and the plan sponsor. Only limited data on participant numbers and plan financial data is required. A series of compliance questions is also included on Form 5500-SF.

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[42] DOL Reg. §2510.103-1.

[43] DOL Reg. §2520.103-1(c)(2), Instructions to Form 5500-SF.

Form 5500-EZ [Annual Return of One-Participant (Owners and their Spouses) Retirement Plan]

The Form 5500-EZ is for plans that are not subject to Title I of ERISA, but for which the IRS requires a filing.

To be eligible for the EZ filing status, the plan must satisfy all of the following conditions:

- The plan is a "one-participant plan" covering only the owner and the owner's spouse (or one or more partners and their spouse(s)) in a business partnership);
- The plan does not provide benefits for anyone except the owner and the owner's spouse (or to one or more partners and their spouses); and
- The plan covered fewer than 100 participants at the beginning of the plan year.

The 5500-EZ filing status is not available for welfare benefit plans or fringe benefit plans.

Only Individuals Who Are Not Title I Employees Are Covered

The only participant or participants in the plan as of the first day of the plan year must be individuals who are not employees for Title I purposes.[44] This means, in essence, that the only participants can be the sole owner of a business that maintains a plan or partners in a partnership that maintains a plan, and any spouse of such individuals.

An individual described in the prior paragraph is not the sole participant if there is at least one employee who qualifies as a participant in the plan, regardless of whether that employee has an account balance.

EXAMPLE 11-3. Eligible Employees With No Account Balances. A corporation owned by a single individual has one employee hired on November 1, 2016. Under the plan's eligibility conditions, that employee becomes eligible for the plan on January 1, 2018. The plan year ends December 31. For the pre-2018 plan years, the only participant is the owner of the corporation and Form 5500-EZ may be filed. But for the 2018 plan year, the plan is not a one-participant plan and the regular Form 5500 (or Form 5500-SF) must be filed. This is true even if the plan is a profit sharing plan with a discretionary contribution formula and, for the 2018 plan year, the newly eligible employee receives no allocation and has a zero account balance.

No Aggregation for Coverage

The plan cannot be aggregated with another plan to satisfy the coverage requirements of IRC §410(b).

No Member of Related Group

The employer that maintains the plan cannot be a member of a controlled group of businesses or an affiliated service group. If the employer is a member of a related group, its plan is not eligible to file a Form 5500-EZ, even if the plan covers only the owner and the other related group members have separate plans.

No Leased Employees

The employer that maintains the plan cannot receive the services of leased employees, as defined in IRC §414(n). If there are leased employees, the Form 5500-EZ is not available and the Form 5500 must be filed.

No Filing Required if Plan Assets Do Not Exceed $250,000

If a plan is eligible to file Form 5500-EZ, but as of the end of the plan year the total value of plan assets was $250,000

[44] DOL Reg. §2510.3-3.

or less, no filing is required. If the employer maintains two one-participant plans (e.g., profit sharing plan and money purchase plan), the combined value of the assets in both plans is taken into account to determine if the $250,000 threshold is reached. If the combined value exceeds $250,000, both plans must file Form 5500-EZ, even if neither plan individually has assets above $250,000.

The $250,000 amount represents an increase from the previous $100,000 threshold. The change was part of PPA, and was effective for plan years beginning in 2007.

This filing exception does not apply in the final year (i.e., the year in which the final distribution of assets occurs), even if the assets are under $250,000 and even if a Form 5500-EZ had never been filed before. In other words, a final Form 5500-EZ is always required, even if no other filing has ever been required.

Counting Participants

A plan's filing status under the annual reporting forms is based on the participant count for the plan as of the beginning of the plan year. How does a plan determine the number of participants for this purpose? Generally, an employee is a **participant** in an employee pension benefit plan as of the beginning of the plan year if he or she has satisfied the plan's eligibility requirements and his or her entry date occurred on or before the first day of the plan year. An employee is a participant in a 401(k) plan if he or she has the right to defer compensation under the plan, regardless of whether the employee actually makes an elective contribution.

Even if an employee's active participation ceases, he or she retains his or her status as a participant until his or her benefits due from the plan are paid in full.[45]

If a terminated participant has no vested rights in his or her benefit, participant status will cease after the participant incurs a one-year break in service.[46]

A common error is to fail to include employees who qualify as participants for the first time on the first day of the plan year. The first day of the plan year is an entry date for most plans. Using the participant count on the last day of the prior plan year will fail to include these employees in the participant count.

EXAMPLE 11-4. Counting Participants for Filings. A qualified plan has 85 participants as of December 31, 2017, the last day of the plan's 2017 plan year. The plan has been filed as a small plan. Because of an acquisition of a large number of employees through an asset purchase in late 2017, an additional 50 participants are made eligible for the plan as of January 1, 2018. For the 2018 plan year, the plan has a participant count of 135 and must now be filed as a large plan. This will affect the schedules attached to the Form 5500, and the plan will have to be audited for the first time for the 2018 plan year. If the participant count had not risen above 120, the plan could have continued to be filed as a small plan under the exception described above.

A plan may provide that a participant's account is forfeited as soon as he or she terminates employment, if he or she is not vested or upon payment of his or her entire vested benefit.[47] Although the plan has an obligation to restore the benefit if the individual later comes forward and presents a valid claim for the benefit, the plan should be able to treat the individual as no longer being a participant for Form 5500 reporting purposes.

Separate Filing Requirements Apply to Each Plan

If an employer maintains two or more plans, a separate Form 5500 must be filed on behalf each plan. This is true even if assets for more than one plan are held in a single trust. DB-K plans, which represent a combination of a defined benefit plan component and a 401(k) component, will be treated as one plan and require a single Form 5500 filing. DB-K plans

[45] DOL Reg. §2510.3-3(d).
[46] DOL Reg. §2510.3-3(d)(3).
[47] Treas. Reg. §1.411(a)-4(b)(6).

are available for plan years beginning in 2010 and later.

Use Forms for Calendar Year in which Plan Year begins

The Form 5500 series is updated on an annual basis. The forms issued for a calendar year should be used for all plan years beginning in that calendar year. For example, the Form 5500 filing for a plan year beginning July 1, 2017, and ending June 30, 2018, should be on the 2017 form. One exception to this is when filings for prior years are past due. In that circumstance, the current Form 5500 may be used for any past filings.

If You're Curious . . .

Filings for Plans Covering Multiple Companies

Two or more employers that constitute a controlled group or an affiliated service group may maintain a single plan for the benefit of their employees. The instructions to the Form 5500 series require such a plan to file only one annual return. To be a single plan, the assets of the plan must be available on an ongoing basis to pay all benefits of the plan.[48] This requirement can be confusing for defined contribution plans, particularly when participants direct their own investments. However, the right of participants to direct their own investments does not, in and of itself, cause the plan to fail to be a single plan. Rather, the manner in which the plan would deal with nondirected investments must be examined. If a plan fails to be a single plan, then the employer sponsoring each plan (i.e., each portion of the plan with assets allocated to pay the benefits of only a single employer) must file its own Form 5500.

Two or more employers that do not constitute a controlled group or an affiliated service group are permitted to maintain a single plan for the benefit of their employees. What are the reporting rules in such cases?

There are three different types of plans that can be adopted by more than one employer:

- multiemployer;
- collectively bargained; and
- multiple employer plans.

A plan is a multiemployer plan if it is maintained under one or more collective bargaining agreements and meets further requirements outlined in ERISA §3(37). If a plan is maintained under one or more collective bargaining agreements (but does not satisfy additional specific requirements for multiemployer plans), it is a collectively bargained plan, but not a multiemployer plan.

If the plan covers employees of more than one unrelated company and is not maintained in relation to a collective bargaining agreement, it is a multiple employer plan [identified as a Multiple-Employer Plan (Other) in the instructions to the Form 5500 series].

Only one Form 5500 is required for each of these plans, although the form will identify which type of multiple employer plan it is.

The rules discussed above, in relation to determining whether a plan maintained by related employers is a single plan, also apply to determine whether a multiple employer plan is a single plan. Within a multiple employer plan, there may be two or more participating employers who are treated as a single employer because they constitute a controlled group of businesses or an affiliated service group.

The DOL has opined that some plans are intended to be multiple employer plans (called "Open MEPs," because they are adopted by completely unrelated employers) may not, in fact, be multiple

[48] Treas. Reg. §1.414(l)-1(b)(1).

employer plans for ERISA purposes. Such plans are considered by the DOL to be a series of individual plans using common documentation. Plans to which such opinion letter applies must file separate Forms 5500 for each portion of the plan maintained by each separate employer.[49]

EXAMPLE 11-5. Single Plan With More Than One Sponsoring Employer. A single plan is maintained by Corporations A, B, C and D. Corporations A and B constitute a controlled group. Corporations C and D are not related to each other and also are not part of the AB controlled group. The plan is treated as having three unrelated employers: the AB controlled group, Corporation C and Corporation D and would file as a multiple employer.

Should Form 5500 be Filed for a New Plan With no Assets at the end of the First Year?

An issue sometimes arises when an employer establishes a new profit sharing plan [no 401(k) feature] with a discretionary contribution and then decides not to fund that plan for the first year. Should a Form 5500 be filed for the first plan year when the plan has no assets at the end of its first plan year? The conservative answer is yes. Regardless of the fact that the employer has decided not to make a contribution for the first plan year, the plan is still in effect, because the written document creates the plan for ERISA purposes. The form would simply show zero assets at the beginning and end of the plan year on the form's financial schedules.

Mandatory Electronic Filing of DOL Forms

The DOL requires that Form 5500 (or Form 5500-SF, if applicable) be filed electronically. The electronic filing is performed using the DOL's program called the ERISA Filing Acceptance System, generally referred to by its acronym, EFAST2.

Form 5500-EZ and One-Participant Plans

Form 5500-EZ is not required to be filed electronically until plan years that begin on or after January 1, 2015, for which the filing is due (not taking into account extensions) on or after December 31, 2015. The IRS has not provided a means of electronic filing of Form 5500-EZ (which only applies to plans that are not subject to Title I so they need not file with the DOL). Until they do, one-participant plans may file Form 5500-SF electronically, rather than completing a paper filing of Form 5500-EZ. One-participant plans require only certain questions on Form 5500-SF to be completed and Form 5500-SF information for "one-participant plans" is not available to the public on the DOL's website.

Electronic Display of Form 5500 Information

Section 504 of PPA requires the DOL to display certain annual report information on its website within 90 days after the date the Form 5500 is filed. This was effective for plan years beginning on or after January 1, 2008 (i.e., Form 5500 information filed for such plan years).[50] The DOL began posting Form 5500 information on its website starting with the 2009 forms electronically filed through EFAST2. A person does not need to have special electronic credentials or a login to access the EFAST2 public disclosure website.

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[49] DOL Advisory Opinion 2012-04A.
[50] ERISA §104(b)(5).

SCHEDULES REQUIRED WITH FORM 5500 FILING

A number of different schedules may need to be filed with the annual report. Unless otherwise noted, the schedule would apply to all filers. The schedules are described below in alphabetical order.

Insurance Information (Schedule A)

This schedule reports information about insurance policies purchased under the plan, including premiums and commissions paid. Schedule A is not required with Form 5500-EZ. Form 5500-SF filers should not include the Schedule A in their filing, but are required to maintain on file all information that would have appeared on the Schedule A. Schedule A contains an item where the plan sponsor may indicate that the insurance company failed to provide the necessary information to complete the schedule. In that case, the plan sponsor must notify the insurance company of its intent to notify the DOL.

Actuarial Information (Schedule B, SB or MB)

IRC §6059 requires that actuarial information for defined benefit plans be provided with the annual return. Prior to 2008, this information was found on Schedule B. For post-2007 years, the one of two schedules replaced the old Schedule B — Schedule SB or Schedule MB, depending on the type of plan.

Schedule SB

This schedule must be filed by most single-employer defined benefit plans and multiple employer defined benefit plans. Schedule SB captures identifying information about the plan and the plan sponsor, the type of plan, the number of participants, basic information about plan assets and funding target information. It also contains a statement that must be signed by the plan's enrolled actuary.

Schedule MB

Schedule MB must be used by multiemployer defined benefit plans, as well as for any money purchase plans with funding waivers, even if they are not multiemployer plans. It also contains a statement that must be signed by the plan's enrolled actuary.

A multiemployer plan is maintained pursuant to one or more collective bargaining agreements to which more than one employer is required to contribute.[51] (Not to be confused with a multiple employer plan — a single plan that is sponsored by two or more unrelated employers.)[52]

Service Provider Information (Schedule C)

This schedule reports direct and indirect compensation paid to service providers, information about the trustees of the plan and information relating to accountants and enrolled actuaries whose services for the plan have been terminated. Only large plan filers must attach this schedule. Generally, only service providers who receive $5,000 or more in reportable compensation directly or indirectly from the plan must be listed on Schedule C.

The information shown on the Schedule C must be provided to the plan by the service providers who receive fee payments. If a service provider does not provide the needed information, the plan administrator may identify the individual on Part II of the Schedule C.

The compensation that must be reported on the Schedule C includes money and any other thing of value (such as gifts, awards, trips) received directly or indirectly from the plan (including fees charged as a percentage of plan assets and

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[51] ERISA §3(37) and IRC §414(f).

[52] IRC §413(c).

deducted from investment returns) for services rendered to the plan. Finders' fees and commissions are also required to be reported.

Direct Filing Entity/Participating Plan Schedule (Schedule D)

The schedule serves two purposes: (1) a standardized form is provided for filing by a **Direct Filing Entity** (DFE), and (2) a form is provided for certain plans to report their participation in a DFE (an investment offered by a financial institution that is required to, or may, file as a DFE). **Master trust investment accounts** (MTIAs) are required to file as a DFE. **Common/collective investment trusts** (CCTs), insurance company **pooled separate accounts** (PSAs), investment entities covered under DOL Reg. §2520.103-12 (103-12IEs) and group insurance arrangements (GIAs) may choose to file as a DFE. [See the "If You're Curious" section below for more details about these types of entities and accounts.]

Financial Schedules (Schedule G)

This schedule is designed for the reporting of financial information (including loans and leases in default and prohibited transactions) on Form 5500. This schedule applies only to large plan filers. Also, DFEs that are MTIAs or 103-12IEs are required to complete this schedule.

Financial Information for Large Plans and DFEs (Schedule H)

Large plan filers and DFEs file this schedule, showing certain financial information about the plan.

Large plan filers must include information about reportable transactions that involve at least 5 percent of plan assets and a schedule of assets.[53] For the first plan year of a plan, the value of assets at the end of the plan year (rather than at the beginning of the plan year) is used to determine five percent reportable transactions.

Reportable transactions do not include transactions affected at the direction of participants or beneficiaries, regardless of whether the plan meets the requirements for modification of fiduciary liability under ERISA §404(c).[54]

Financial Information for Small Plans (Schedule I)

Small plans that are not eligible to file Form 5500-SF must include this schedule with Form 5500, showing certain financial information about the plan. The information provided is much less extensive than the information reported on Schedule H. No Schedules are required to be filed with Form 5500-SF.

Pension Plan Information (Schedule R)

This schedule is required for both large and small pension plan filers filing Form 5500. For this purpose, the term "pension" refers to plans that are subject to minimum funding requirements under IRC §412. No Schedules are required to be filed with Form 5500-SF. This schedule is not required when filing on behalf of nonpension plans.

The schedule reports certain information about the plan's participants, plan distributions and funding, and the adoption of amendments increasing the value of benefits in a defined benefit plan.

A table summarizing the filing requirements for the 5500-Series Forms and Schedules is at the end of this chapter.

Audit by Independent Qualified Public Accountant

In addition to the other requirements previously outlined, a large plan must provide an accountant's report prepared

[53] See DOL Reg. §§2520.103-6 , 2520.103-10 and 2520.103-11.

[54] DOL Reg. §2520.103-6(f).

by an independent qualified public accountant with regard to the plan assets. These rules are discussed in a separate section below.

If You're Curious . . .

Special Filing Requirements and Additional Information Required with Respect to Certain Form 5500 Filings

The regulations require special filing requirements for certain entities in which plans might invest. The instructions to Form 5500 refer to these entities as Direct Filing Entities (DFEs). Master trust investment accounts (MTIAs), common/collective investment trusts (CCTs), insurance company pooled separate accounts (PSAs), investment entities covered under DOL Reg. §2520.103-12 (103-12IEs), and group insurance arrangements (GIAs) are possible DFEs. In addition, banks and insurance companies that hold assets for a plan, including assets that are not held in CCTs or PSAs, are required by regulation to transmit and certify to the plan certain information about such assets.

Assets Held by Bank or Insurance Company

Some plans hold investments with a bank, trust company, or similar institution (collectively referred to as a bank) in the bank's common trust fund or collective investment trust fund (collectively referred to as common collective investment trusts or CCTs). Some plans invest in an insurance company's PSA or provide for benefits that are payable from the general assets of an insurance company. Recognizing that the banks and insurance companies are subject to independent review by other agencies, the DOL has provided special reporting rules regarding these plan investments.

CCTs. The annual return must include information regarding the plan's units of participation in the CCT (provided in Schedule D), but does not have to report information about the individual transactions of that fund so long as the CCT satisfies certain reporting requirements prescribed by the regulations.[55] If the bank files a separate statement of the CCT's assets and liabilities, the Form 5500 filed by the administrator of the participating plan need not include an annual statement of the assets and liabilities of the CCT.[56] The CCT will satisfy the separate statement requirement only by filing Form 5500 as a DFE.

PSAs. The annual return must include information regarding the plan's units of participation in the PSA (provided in Schedule D), but does not have to report information about the individual transactions of that account so long as the PSA satisfies certain reporting requirements prescribed by the regulations.[57] If the insurance company files a separate statement of the PSA's assets and liabilities, the Form 5500 of the administrator of the participating plan need not include an annual statement of the assets and liabilities of the PSA.[58] The PSA will satisfy the separate statement requirement only by filing Form 5500 as a DFE.

Transmittal and Certification of Information to Plan Administrator

Specific information must be transmitted to the plan administrator by the bank or insurance company with respect to a plan's investments with that institution.[59] For a bank, this applies to assets of a plan held in a CCT, a separate trust or custodial account.[60] For an insurance company, this applies to

[55] DOL Reg. §2520.103-3.
[56] DOL Reg. §2520.103-9.
[57] DOL Reg. §2520.103-4.
[58] DOL Reg. §2520.103-9.
[59] DOL Reg. §2520.103-5.
[60] DOL Reg. §2520.103-5(b)(2).

assets of a plan held in a PSA as well as to an insurance company which provides for the payment of benefits under a plan from the insurance company's general asset account. This information must be provided within 120 days after the close of each participating plan's plan year.[61] The purpose of this requirement is to ensure the plan administrator will have sufficient information to file a complete annual return. The information that must be provided to the plan by the bank or insurance company depends on how assets are held with the bank or insurance company and, in the case of a CCT or PSA, whether the CCT or PSA files a Form 5500. The CCT or PSA must notify (within the 120-day period) its participating plans of whether or not it intends to file Form 5500 as a DFE.

With respect to a CCT or PSA that elects to file Form 5500, the Form 5500 must include Schedule D, to list the participating plans, and Schedule H. Large plans that invest in the CCT or PSA are then able to report the value of their interests in these entities on one line in the plan's Schedule H as of the beginning and end of the plan year, and as a single entry for net investment gain/loss.[62]

If the CCT or PSA does not file Form 5500 as a DFE, the participating plans that are large plans would have to break out their percentage interest in the underlying assets of the CCT or PSA and report the dollar value in the appropriate categories in the Schedule H statement of assets and liabilities.[63]

With respect to an insurance company that provides funds from its general asset account for the payment of benefits, the information that must be transmitted and certified to the plan, upon request of the plan administrator, is such information as is contained within the ordinary business records of the insurance carrier and is needed by the plan administrator to comply with its reporting obligations.[64]

The bank must transmit and certify to the plan administrator a listing of all transactions of the separate trust and, upon request, such information as is contained within the ordinary business records of the bank and is needed by the plan administrator to comply with its reporting obligations.[65]

The bank, upon request of the plan administrator, must transmit such information about the custodial account as is contained within the ordinary business records of the bank and is needed by the plan administrator to comply with its reporting obligations.[66]

Limited Scope on Accountant's Report

The accountant's report for a plan that invests in the type of assets described above need not extend to any statement or information prepared and certified by a bank or insurance company under these special reporting requirements.[67]

The DOL notes that this limited scope rule does not excuse the participating plan from the audit requirement, even if 100 percent of plan assets are invested in an insurance company's guaranteed contract that is subject to the certification requirements described above.[68] The DOL's view would be the same if 100 percent of assets were held in pooled separate accounts or in a bank's common or collective fund.

[61] DOL Reg. §2520.103-5(a).
[62] Also see DOL Reg. §2520.103-5(c)(1)(ii) (relating to PSAs) and §2520.103-5(c)(2)(I) (relating to CCTs) for more details on information that must be reported to the plan by these CCTs and PSAs.
[63] Also see DOL Reg. §2520.103-5(c)(1)(iii) (relating to PSAs) and §2520.103-5(c)(2)(ii) (relating to CCTs) for more details on information that must be reported to the plan by these CCTs and PSAs.
[64] DOL Reg. §2520.103-5(c)(1)(I).
[65] DOL Reg. §2520.103-5(c)(2)(iii).
[66] DOL Reg. §2520.103-5(c)(2)(iv).
[67] DOL Reg. §2520.103-8.
[68] DOL Advisory Opinion 85-12A.

Plan Administrator Has Obligation to Determine Whether Certifications Prepared by Representatives of a Financial Institution Satisfy the Certification Requirements

The American Institute of Certified Public Accountants submitted six examples of certifications and requested an opinion from the DOL on whether the certifications satisfy the DOL requirements, as described above. The DOL responded to that inquiry in an Information Letter dated May 17, 2002.

Rather than render an opinion on any of the particular examples, the DOL instead describes the plan administrator's responsibility to determine whether the conditions for limiting the scope of an auditor's examination have been satisfied. If there is a question as to whether the party providing the certification is an authorized representative of the financial institution, which may be the case if there is not an explicit statement of such authority included as part of the certification, the administrator must take steps to resolve this question before authorizing limited scope reporting.

The DOL also opines on two other issues. First, in addition to determining whether the conditions for the limited scope audit have been satisfied, administrators should take steps to make sure they understand the nature and scope of the certification the institution has provided before concluding that the certified information may be used to satisfy the administrator's obligation to report the current value of the assets on the plan's Form 5500. Second, the DOL discusses the responsibility of the independent qualified public accountants engaged to conduct the audit of the plan. Independent qualified public accountants should, as part of their audit engagement, review certifications and notify plan administrators of potential problems with a certification when there may be a question as to whether the furnished certification provides an appropriate basis on which the administrator may limit the scope of the plan's audit or provides a basis for reporting the current value of plan assets on the Form 5500.

MTIAs

Additional reporting requirements are imposed on plans that are invested in MTIAs.[69] A master trust is a trust for which a regulated financial institution (bank, trust company or similar financial institution regulated by a state or federal agency) serves as trustee or custodian, and in which assets of more than one plan maintained by the same employer or by the same related group of employers is invested. For example, if an employer maintains a 401(k) plan and a money purchase plan, and those plans are invested in a master trust with a regulated financial institution that is an MTIA under the reporting rules. An MTIA must make a separate filing with the DOL, no later than when the annual returns of the investing plans are due. The instructions to Form 5500 enumerate the information that must be supplied with the annual return of each investing plan and in the separate filing of the MTIA, and provide a special mailing address for sending the separately filed information. The MTIA must file a separate Form 5500 with the following schedules: Schedule A if applicable, Schedule C, Schedule D, Schedule G if applicable, and Schedule H.

103-12 Investment Entities

In its definition of plan assets, the DOL has included the underlying assets of certain entities in which a plan invests. These entities are generally companies that are considered nonoperating companies under the regulations and in which 25 percent or more of the equity interests are owned by employee benefit plans.[70] Where the underlying assets of an entity are treated as assets of the investing plans, the annual return filed by the investing plan must include information about those underlying assets. To ease the reporting burdens created by this rule, the DOL has outlined an alternative reporting method in DOL Reg. §2520.103-12. The part of this regulatory citation that appears to the right of

[69] DOL Reg. §2520.103-1(e).
[70] DOL Reg. §2510.3-101.

the decimal point, 103-12, is used by the DOL to identify this alternative reporting method in the instructions to Form 5500. The alternative method allows the 103-12 investment entity (abbreviated as 103-12 IE) to report information directly to the DOL on behalf of the plan investors. The annual return for each plan that is invested in the 103-12 IE only has to include the current value of its investment or units of participation in the 103-12 IE. The 103-12 IE must file a separate Form 5500 with the following schedules: Schedule A if applicable, Schedule C, Schedule D, Schedule G if applicable, and Schedule H.

SUMMARY OF FORM 5500 AND APPLICABLE SCHEDULES

Form/Schedule	Large Pension Plan	Small Pension Plan	Comments
Form 5500	Required, unless filing exemption applies	Required unless eligible to file Form 5500-SF or Form 5500-EZ, or a filing exemption applies	
Form 5500-SF	Not applicable	Filed in lieu of Form 5500 if eligibility conditions are satisfied	Available to 403(b) plans that meet the eligibility conditions for filing.
Form 5500-EZ	Not applicable	Filed in lieu of Form 5500 or Form 5500-SF if eligibility conditions are satisfied	Available to one-person plans (owners & spouses or partners & spouses). No filing required if assets are <$250,000 unless final plan year.
Schedule A (Insurance Information)	Must complete if plan has insurance contracts	Must complete if plan has insurance contracts	Not applicable if Form 5500-SF or Form 5500-EZ filer
Schedule C (Service Provider Information)	Must complete if service provider was paid $5,000 from plan assets or if an accountant or actuary was terminated	Not applicable	
Schedule D (DFE/ Participating Plan Information)	Must complete if plan participated in a CCT, PSA, MTIA or 103–12 IE	Must complete if plan participated in a CCT, PSA, MTIA or 103–12 IE	Not applicable if Form 5500-SF or Form 5500-EZ filer
Schedule G (Financial Schedules)	Must complete if Schedule H line 4b, 4c or 4d was "yes". Schedule of assets and reportable (5%) transactions must be filed if Schedule H line 4i or 4j is "yes"	Not applicable	
Schedule H (Financial Information)	Not applicable	Not applicable	
Schedule I (Small Plan Financial Information)	Not applicable	Must complete	Not applicable if Form 5500-SF or Form 5500-EZ filer
Schedule MB (Actuarial Information)	Must complete if multiemployer defined benefit plan or money purchase pension plan subject to minimum finding waiver	Must complete if multiemployer defined benefit plan or money purchase pension plan subject to minimum finding waiver	Not applicable to Form 5500-EZ filer

Form/Schedule	Large Pension Plan	Small Pension Plan	Comments
Schedule R (Pension Plan Information)	Must complete unless filing exemption applies	Must complete unless filing exemption applies	Not applicable if Form 5500-SF or Form 5500-EZ filer
Schedule SB (Actuarial Information)	Must complete if single-employer or multiple-employer defined benefit plan and subject to minimum finding standards	Must complete if single-employer or multiple-employer defined benefit plan and subject to minimum finding standards	Must be completed by plan actuary and retained in plan records, but is not submitted with Form 5500-EZ

ANNUAL REGISTRATION STATEMENT IDENTIFYING SEPARATED PARTICIPANTS WITH DEFERRED VESTED BENEFITS (FORM 8955-SSA)

As discussed above, Form 8955-SSA replaced Schedule SSA for plan years beginning on or after January 1, 2009.[71] This form is used to report deferred vested benefits to the IRS and the Social Security Administration. (The "SSA" in the form's name stands for the Social Security Administration, which keeps track of participants who separate from service with deferred vested benefits in a plan.) Deferred vested benefits are benefits in which the participant has a vested interest, but the payment of which is postponed.

Form 8955-SSA lists, by name and Social Security number, the separated participants who have deferred vested benefits under the plan. A participant must be included on the Form 8955-SSA that is filed for the plan year following the plan year in which he or she separates from service. Alternatively, the plan administrator may elect to include the participant on the Form 8955-SSA filed for the plan year in which the separation from service occurs. If the plan is maintained by more than one employer, the deadline is not until the plan year in which the participant incurs the second of two consecutive breaks in service.[72]

EXAMPLE 11-6. Employee Terminates With Deferred Vested Benefit. Betsy terminates employment with Corporation B on August 15, 2017. She has a vested account balance in Corporation B's profit sharing plan. She does not take a distribution of her benefit in either 2017 or 2018. Although Corporation B may report Betsy on its Form 8955-SSA for 2017, it does not need to do so; the customary deadline for reporting terminated vested participants is for the plan year following the year in which severance of employment occurred. Betsy must be included on the 2018 Form 8955-SSA for Corporation B's profit sharing plan.

Do not include the participant on Form 8955-SSA if, before the participant must be included on Form 8955-SSA, any of the following has occurred:

- Payment of the benefit has commenced;
- The participant has returned to covered service; or
- The benefits have been forfeited.

Presumably, a forfeiture would include the forfeiture of a missing participant's benefit.[73]

EXAMPLE 11-7. Employee Terminates With No Deferred Vested Benefit. Suppose in the prior **EXAMPLE 11-6**, Betsy took a distribution of her vested balance on January 15, 2018. Again, Betsy may be reported on Corporation B's form 8955-SSA for 2017, but it is not required. The customary reporting of Betsy for Form 8955-SSA purposes is during the plan year following the year in which she terminated employment (i.e., 2018). However, before that due date, payment of her benefit oc-

[71] IRS Announcement 2011-21.
[72] Treas. Reg. §301.6057-1(a)(5) (for a plan maintained by one employer) and 301.6057-1(b)(2) (for a plan maintained by two or more employers).
[73] Treas. Reg. §1.411(a)-4(b)(6).

curred. As a result, she need not be reported on the Corporation B profit sharing plan's Form 8955-SSA for 2018.

EXAMPLE 11-8. Employee Returns to Covered Service. Suppose in the prior **EXAMPLE 11-6**, Betsy was rehired on November 15, 2018. Again, Betsy would not need to be reported on the Form 8955-SSA for 2017, because reporting is first required in the plan year following the plan year in which she separated from service (the 2018 plan year). Betsy would also not have to be reported on the Form 8955-SSA for 2018, because she has returned to covered service and resumed participation in the Corporation B's profit sharing plan before the form was due.

Once a participant has been included on the plan's Form 8955-SSA, he or she does not need to be included on the Form for subsequent years, even if the benefit remains unpaid. A participant should be reported on a subsequent Form 8955-SSA only if there is a need to revise or update information contained on a prior Form 8955-SSA. In particular, if a participant later commences payment of benefits (or forfeits benefits) that were reported as deferred vested benefits on a previously filed Form 8955-SSA, the plan administrator is required to show the change of information on a Form 8955-SSA filed for a later plan year.

EXAMPLE 11-9. Previously Reported Employee Takes a Lump Sum Distribution. Ted terminated employment with Company Y on June 3, 2014. Ted had a vested balance in Company Y's 401(k) plan and he had not taken a distribution of his vested account balance as of December 31, 2015. Ted's deferred vested benefit was reported on the Company Y 401(k) plan's 2015 Form 8955-SSA (the plan year following the plan year in which he separated from service).

As of December 31, 2016, Ted had still not taken a distribution of his vested account balance. Ted need not be included on the Company Y 401(k) plan's 2016 Form 8955-SSA as his deferred vested benefit was previously reported and no changes have taken place.

Ted takes a distribution of his vested account balance on August 31, 2017. The Company Y 401(k) plan must include Ted on the 2017 Form 8955-SSA with a revised balance of $0 indicating that he no longer has a deferred vested benefit in the plan.

The filing deadline for Form 8955-SSA is the last day of the seventh month following the close of the plan year. For example, the deadline is July 31, 2018, for a plan year ending December 31, 2017. If the filing deadline falls on a Saturday, Sunday or Federal holiday, the due date is the next day that is not a Saturday, Sunday or Federal holiday. To obtain a filing extension, the plan administrator may file **Form 5558**. The maximum extension is 2½ months. For example, a return due July 31, 2018, may be extended to October 15, 2018. Form 5558 must be filed no later than the normal due date (i.e., seven months after the plan year end) for filing Form 8955-SSA.[74]

Form 8955-SSA may be submitted electronically using third-party software and IRS' Filing Information Returns electronically (FIRE) system. Electronic filing is optional for some plans, however, some filers are now required to file the form electronically. A filer must file the 2017 Form 8955-SSA electronically if the filer is required to file 250 returns of any type during the calendar year that include the first day of the plan year. "Returns" for this purpose include information returns (e.g., Form(s) W-2 and Form(s) 1099), income tax returns, employment tax returns and excise tax returns. If a filer is required to file a Form 8955-SSA electronically but does not, the filer is considered not to have filed the form even if a paper return is submitted. The IRS may waive the requirements to file Form 8955-SSA electronically in cases of undue economic hardship.

If there is no information to file for a plan year, a plan administrator does not have to file Form 8955-SSA. A single Form 5558 may be filed to extend Form 5500 and Form 8955-SSA. Lines 2 and 3 in Section II of Form 5558 must both be completed to initiate extensions for both forms.

[74] Instructions to Form 8955-SSA.

If You're Curious…

Employer Has Duty to Maintain Records Regarding Benefits Due

The employer must maintain records with respect to each of its employees sufficient to determine the benefits due or which may become due to such employees.[75] The six-year period for record retention that is required by ERISA §107 does not, in the DOL's opinion, apply to the obligation to maintain sufficient records of benefits due. This was expressed in an informal Q&A technical session between the DOL and the Joint Committee on Employee Benefits (JCEB) of the American Bar Association, held on May 8, 2002. The DOL noted that it would not be appropriate to shift the burden to the participant as to whether benefits had already been paid where a benefit claim is made more than six years after the reporting of deferred vested benefits on Form 8955-SSA. In an example addressed in the session, the participant's benefit claim was made in 2002, the individual had terminated in 1980, the individual's benefit was reported on Schedule SSA in 1981, and in the 1990s the plan sponsor (Company X) was acquired and the acquiring company (Company Y) was now the plan sponsor. Company Y was not able to find a record of the individual. The DOL noted that reporting changes could have alleviated the problem because it would have notified the Social Security Administration and the participant that the benefits had been paid or commenced. Also, as part of a merger or acquisition, it would be good plan administrative practice for deferred vested benefits to be reviewed by the successor sponsor to ensure that appropriate recordkeeping is maintained.

WHEN IS THE FORM 5500 FILING DUE?

The filing deadline for Forms 5500, 5500-SF and 5500-EZ is the last day of the seventh month following the close of the plan year. For example, the deadline is July 31, 2018, for a plan year ending December 31, 2017. If the plan year does not end on the last day of a month, the deadline is the last day of the seventh full calendar month that begins after the last day of the plan year. For example, if a plan year ends June 15, the deadline would be the next January 31, because January is the 7th calendar month following the month in which the plan year ended (June).[76]

If the filing deadline falls on a Saturday, Sunday or Federal holiday, the due date is the next business day (i.e., the next day that is not a Saturday, Sunday or Federal holiday).

Although the Form 5500 filing deadlines are identical to those for Form 8955-SSA, the two filings need not be filed concurrently. Remember that Forms 5500 and 5500-SF are filed with the DOL, while Forms 5500-EZ and 8955-SSA are filed with the IRS.

Extensions

To obtain a filing extension, the plan administrator may file **Form 5558**. The maximum extension is 2½ months. For example, a return due July 31, 2018, may be extended to October 15, 2018. Form 5558 must be filed no later than the normal due date (i.e., seven months after the plan year end) for filing Form 5500.

Automatic Extension If Employer's Tax Return is on Extension

If the employer's tax year matches the plan year and the tax return is on extension, that extension automatically applies to the Form 5500 filing for that plan year.[77] A copy of the employer's tax return extension must be included with the Form 5500 filing. The additional time granted through this automatic extension might not equal the maximum exten-

[75] ERISA §209.
[76] DOL Reg. §2520.104a-5 and the instructions to the Form 5500.
[77] See the instructions to Form 5558.

sion available. If the maximum extension of 2½ months is desired, Form 5558 must be filed no later than the normal due date of the Form 5500 filing.

EXAMPLE 11-10. Partnership. A partnership has a taxable year ending December 31 and maintains a qualified plan with a plan year ending December 31. The 2017 Form 5500 is normally due July 31, 2018. The partnership's federal income tax return for 2017 is extended to September 17, 2018. The Form 5500 is automatically extended to September 17, 2018, without having to file Form 5558. But if the employer wants a 2½ month extension on the Form 5500, to October 15, 2018, the Form 5558 must be filed by July 31, 2018 (not by September 17, 2018), to qualify for automatic approval of the extension.

Form 5558 Automatically Approved if Filed by Normal Due Date

Form 5558 provides for automatic approval of an extension to file the Form 5500 series return, so long as Form 5558 is filed on or before the normal due date of the annual return.

No Further Extension Through Form 5558 If Tax Return Deadline Already Includes the Maximum 2½-Month Extension Period

If the employer's extended due date for its tax return takes the Form 5500 deadline to the end of the maximum 2½-month extension period, no further extension is available through the Form 5558. For example, consider a sole proprietor with a calendar tax year who can extend his or her federal income tax return (Form 1040) to October 15. If the sole proprietor's plan is also on a calendar year, an extension of the tax return to October 15 also extends the Form 5500 return deadline to that date. Because October 15 is 2½ months after the normal deadline of July 31, no further extension can be obtained by filing Form 5558.

If You're Curious . . .

Extensions Granted by Agency Action

In some situations, the governmental agencies will extend the filing deadline due to special circumstances—such as modifications in procedures or forms or tragic events such as the 2001 terrorist attacks. Also, natural disasters, such as hurricanes (e.g., Harvey and Maria), earthquakes and floods, will sometimes prompt extensions of filing periods.

Short Plan Year

There is no exception to the filing deadline for short plan years. Thus, a Form 5500 filing is required within seven months following the close of the short plan year (unless an extension applies). A combined filing is not permitted for the short plan year and the plan year that precedes or follows that short year. The maximum period of time for which a Form 5500 may report is twelve months.

EXAMPLE 11-11. Short Plan Year. A corporation amends its 401(k) plan to change the plan year from a September 30 plan year end to a December 31 plan year end. The amendment is effective January 1, 2018, creating a short plan year of October 1, 2017, through December 31, 2017. The Form 5500 filing for the short plan year is due July 31, 2018 (i.e., seven months after the close of the short plan year), unless an extension is obtained.

Suppose this corporation's tax year ends September 30 and is not changed. Any extension on the corporation's tax return for a tax year ending after September 30, 2017, will not result in an automatic extension for the plan's Form 5500 filing, because the plan year will no longer match

the tax year. Form 5558 will have to be filed to obtain any filing extensions.

Final Distribution of Assets Creates Short Reporting Period

A terminated plan must make a final Form 5500 filing.[78] There is a box to check on the Form 5500 to indicate it is the final return. The final return is filed for the plan year in which the final distribution of assets occurs, which is not necessarily the year in which the plan termination date falls. The Form 5500 instructions state that the date on which final distribution of assets occurs ends the plan year for reporting purposes, creating a short plan year. The return is due on the last day of the seventh calendar month following the end of the month that includes the final distribution, unless an extension is granted. If the current year Form 5500 series is not available yet, use the latest form available and indicate the reporting period.

EXAMPLE 11-12. Form Unavailable. Suppose a calendar year plan terminated in June of 2017, but final distribution of assets is not completed until March 20, 2018. The final return is for the short plan year from January 1, 2018, through March 20, 2018. The return would be due October 31, 2018, because October is the seventh calendar month following the month in which the short period ends (March). If the 2018 Form 5500 series is not available yet, the final return may be submitted on the 2017 form.

If a plan is frozen, but not terminated, the normal filing requirements continue to apply. A final return is not made until the year in which all assets have been distributed. Remember that a final Form 5500-EZ is required for an owner-and-spouse-only plan, even if none has been required for prior years.

If You're Curious . . .

Merger Creates Short Period for Plan That Does Not Survive the Merger

If a plan is involved in a merger transaction that results in complete distribution of its assets to one or more other plans, the plan will file a final return for the year in which the last of the assets have been transferred to the other plan or plans. This is true even though the surviving plan may be treated as a continuation of the prior plans for certain purposes. For reporting purposes, the plan that does not survive in the merger transaction (i.e., the plan subsumed by the merger) must end its reporting cycles by filing a final return.[79]

EXAMPLE 11-13. Merger of Plans. Company X acquires the stock of Company Y. As part of the acquisition, the employees of Company Y become eligible to participate in the Company X plan. Company X decides to merge the 401(k) plan sponsored by Company Y into its 401(k) plan to maintain continuity of benefits for the acquired employees. The merger is effective as of September 30. Company X's 401(k) plan is the surviving plan. The Company X plan continues to file its Form 5500 on the normal filing cycle. For the reporting year that includes the September 30 merger, Company X's plan will show a receipt of assets from Company Y's plan. The Company Y plan does not survive the merger, and treats its assets as completely distributed on the September 30 merger date, when title to the plan assets is transferred to Company X's plan. A final Form 5500 is filed for Company Y's plan for the year ending September 30. If the plan year did not otherwise end on September 30, the final return is for a short filing period.

Where a merger results in a short reporting period for a plan involved in the merger, a separate ac-

[78] ERISA §101(c).

[79] *PWBA v. US Airways, Inc.*, 24 EBC 2604 (Office of Admin. Law Judges, PWBA, June 9, 2000).

countant's report must be prepared for that short period. In *PWBA v. US Airways, Inc.*,[80] the employer argued that, because the merger was really the continuation of both plans, the accountant's report prepared for the merged plan for the year in which the merger occurred could also be attached to the Form 5500 filed by the plan being subsumed in the merger. The Administrative Law Judge concluded that a separate accountant's report had to be prepared for the plan that ceased to exist as a result of the merger. The report needed to cover the period from the beginning of the plan year in which the merger occurred through the date of the merger.

Deadlines for DFEs

A GIA's Form 5500 is due by the end of the seventh month following its fiscal year (unless an extension is obtained by the GIA by filing Form 5558). For other DFEs (i.e., CCTs, PSAs, MTIAs and 103b-12IEs), the DFE's return is due 9½ months after the close of the DFE's fiscal year that ends with or within any participating plan's year. This provides a predictable filing date for DFEs while also ensuring that all DFE filings will be due on or before the latest annual report due date for any participating plan, regardless of the plan's reporting year.

Penalties for Failing to File or for Deficient Filings

There are significant penalties that apply to a failure to file the annual return (and required schedules) on a timely basis. Both the IRS and DOL have authority to impose penalties.

The IRS penalties apply only to plans that are subject to the filing requirement under IRC §6058 (generally qualified plans and funded deferred compensation plans). The DOL penalties apply only to plans that are covered by Title I of ERISA and are not otherwise exempt from filing. Therefore, DOL penalties do not apply to Forms 5500-EZ, which are designed to apply only to plans that are not subject to Title I of ERISA. If the plan is subject to both IRS and DOL filing requirements, then both penalties will apply to a late filing.

IRS Penalty

The IRS penalty is $25 per day with a maximum penalty of $15,000 (applicable after 600 days) with respect to the filing required for a plan year.[81]

If You're Curious . . .

The IRS must make demand for payment, and has the authority to reduce or excuse the penalty for reasonable cause. A reasonable cause statement may be attached to a late-filed Form 5500, or in response to an assessment of penalties for a late filing, to request the elimination or reduction of late filing penalties. The penalty may be imposed on the plan administrator or the employer, depending on who is responsible for the filing.[82] The Treasury defers to the instructions for the Form 5500 series to determine who is responsible for filing the form.[83] Those instructions state that either the plan administrator or employer may file the form, so the penalty may be imposed on either party.

The IRS takes the position in a general counsel memorandum that these penalties also may apply to a filing that is materially incomplete (i.e., a significantly incomplete filing may be treated as if the return were not filed). Under exceptional circumstances where the penalty has proven to be ineffec-

[80] 24 EBC 2604 (Office of Admin. Law Judges, PWBA, June 9, 2000).
[81] IRC §6652(e).
[82] Treas. Reg. §301.6652-3(a)(3).
[83] Treas. Reg. §301.6058-1(b).

tive in securing compliance with the filing requirements, the IRS may disqualify a plan for failing to comply with this reporting requirement.[84]

DOL Penalty

The DOL may impose a civil penalty of up to $2,097 per day with no limit.[85] The original daily cap was $1,000, but it is subject to inflation adjustment. The DOL will seek maximum penalties only in rare circumstances. Its normal penalty assessment for a late filer is $300 per day up to $30,000 per year until a complete return is filed.[86] DOL regulations outline assessment procedures for this civil penalty.[87] The penalty is imposed on the plan administrator.

Penalty on missing items. The DOL may impose a penalty for certain missing items, even if the Form 5500 filing is timely.

If You're Curious . . .

The DOL has indicated that it typically will assess the following penalties for deficiencies:

- $150 per day for missing accountant's report ($50,000 cap);
- $100 per day for financial reporting items ($36,500 cap); and
- $10 per day for other report items ($3,650 cap).

Separate Penalties for Certain Schedules

The IRC imposes separate penalties on a failure to file Schedules SB and MB and Form 8955-SSA. The penalty for the Schedules SB and MB is $1,000, regardless of how late the filing is made.[88]

The penalty for Form 8955-SSA is based on the number of participants that should have been reported on the schedule. This penalty is $1 per day, per participant, up to $5,000 per plan year.[89] If no Form 8955-SSA is filed, the penalty is calculated on the basis of the total number of participants that should have appeared on the schedule. If a Form 8955-SSA is filed but participants are omitted, then the penalty would be based on the number omitted.

The IRS must demand these penalties and may waive or reduce the penalty for reasonable cause. In Rev. Rul. 84-54,[90] the IRS clarified that its general penalty of $25 per day would not apply solely because of a failure to file either Schedule SB or MB or Form 8955-SSA. However, if any other required schedule is not filed with the return (e.g., Schedule A), the filing is incomplete and the general penalties described above may apply. Because the separate penalties for failure to file Schedule SB or MB and Form 8955-SSA are imposed by the IRC, the DOL presumably would not impose its penalty where the only deficiency in the return submitted was a failure to include one of those three IRS forms, although the DOL has not expressed an opinion on this issue.

The plan administrator is liable for the penalty on a late Form 8955-SSA filing.[91] Similarly, the plan administrator is liable for the Schedule SB or MB penalty.[92]

[84] GCM 38943.
[85] ERISA §502(c)(2).
[86] News Release No. 92-158.
[87] DOL Reg. §2560.502c-2.
[88] IRC §6692.
[89] IRC §6652(d).
[90] 1984-1 C.B. 260.
[91] Treas. Reg. §301.6652-3(a)(1).
[92] Treas. Reg. §301.6692-1.

REDUCTION OF PENALTIES UNDER DOL'S DFVC PROGRAM

The **Delinquent Filer Voluntary Compliance Program** (DFVC Program) provides plan sponsors with a means of filing late returns voluntarily in exchange for a significantly reduced DOL late filing penalty. Because DFVC is a DOL-sponsored program, late Forms 5500-EZ cannot be filed under this program.

The IRS has effectively endorsed the DFVC program by agreeing to waive its late filing penalties for any plan for which late filing has been resolved under DFVC.[93]

Reduced Penalties under DFVC

The basic late filing penalty under the DFVC Program is $10 per day. For example, if a Form 5500 is filed 30 days late and is submitted under the DFVC Program, the penalty is $300. The per-day penalty runs from the date the annual report was due, determined without regard to possible extensions. This basic penalty applies regardless of the size of the plan.

If the plan is a small plan filer (a plan with fewer than 100 participants at the beginning of the plan year) or a plan that is treated as a small plan filer under the 80-120 Rule, the maximum penalty for a single late Form 5500 is $750. As the basic penalty is $10 per day, this per-return cap is reached once the return is at least 75 days late.

If the plan is a large plan filer (a plan with 100 or more participants at the beginning of the plan year) or a plan that is treated as a large plan filer under the 80-120 Rule, the maximum penalty for a single late Form 5500 is $2,000. As the basic penalty is $10 per day, this per-return cap is reached once the return is at least 200 days late.

The DFVC Program also has a per-plan cap, which provides a maximum penalty for plans that have failed to file for multiple years and seek DFVC relief with respect to those multiple years. This should encourage plans that have not filed Form 5500 for several years (or maybe have never filed the form) to seek voluntary relief.

If You're Curious . . .

The per-plan cap is $1,500 for small plan filers and $4,000 for large plan filers. The applicable per-plan cap is twice the maximum per-return cap. So, the fee for multiple plan year filings generally equals twice the per-plan cap, regardless of whether only two plan years are involved or many more than that. The only time a multiple-plan-year DFVC filing will have a lower fee is if only two plan years are involved and, for the more recent plan year, the maximum per-return cap described above has not been reached for that plan year.

If a small plan is sponsored by a tax-exempt organization, the per-plan cap is $750 per DFVC submission, which is the same as the per-return cap. This special cap does not apply if, as of the date of the DFVC submission, there is a delinquent or late annual report due for a plan year for which the plan was a large plan filer. The per-plan cap for a small plan filer applies only if the plan is a small plan filer for all plan years involved in the DFVC submission.[94]

DFVC Procedures

There are two steps to obtaining penalty relief under the DFVC Program. One is to file the late returns and the other is to file the DFVC submission with payment of the applicable penalty.

Filing of Late Returns

A completed Form 5500 must be filed for each plan year for which DFVC relief is sought. Each Form 5500 must include

[93] IRS Notice 2014-35, 2014-23 I.R.B. 1072

[94] Section 3.03(c)(3) of the DFVC Program.

the required schedules and attachments.[95] Delinquent or amended filings for all prior plan years are subject to the mandatory electronic filing requirement after 2009, even if a paper filing option was available in such prior year and, in the case of an amended filing, even if the original filing had been submitted on paper.[96] The electronic filing requirement does not change a plan administrator's obligation to retain records, pursuant to ERISA §§107 and 209. Accordingly, even though the Form 5500 is filed electronically, a fully signed copy of the return must be maintained in the sponsor's files for a minimum of seven years.

To assist in determining which versions of Form 5500 and schedules should be used for an amended or delinquent filing, the DOL has added a Form 5500 Version Selection Tool to its website at http://www.dol.gov/ebsa/5500selectorinstructions.html.

DFVC Submission With Payment

Penalty payments associated with a delinquent filing are not submitted to EFAST2. The penalty payment is attached to the separate DFVC submission. If more than one plan is involved, a separate DFVC submission must be made for each plan. Note that separate per-plan caps apply to each plan.

There is an online calculator that assists with determining the total DFVC Program fee with a direct link to an online payment system that accepts credit card payments. The DOL encourages this paperless process to increase efficiencies for plan sponsors and to eliminate the potential for processing errors. The DFVC fee may be calculated and paid online at https://www.askebsa.dol.gov/dfvcepay/calculator. Payment by check is still accepted, but must be sent in with a paper copy of each applicable Form 5500 (pages 1 and 2) to ensure accurate processing.

The penalty under the DFVC Program is a personal liability of the plan administrator and, thus, may not be paid from plan assets.[97] Payment of the penalty with plan assets would constitute a prohibited transaction and also would violate the exclusive benefit rule.

Participation in DFVC Program Automatically Waives IRS Penalty

The IRS does not have a program comparable to the DOL's DFVC Program, although, as noted above, participation in the DFVC Program will result in waived IRS penalties.[98] Furthermore, the Employee Plans Compliance Resolution System (EPCRS), which provides mechanisms for resolving qualification failures under a plan, is not available to resolve penalties for late filing of the Form 5500 series.[99]

DFVC filers do not need to make a separate application to the IRS for relief from the IRC penalties. The IRS will coordinate with the DOL in determining which late filers are eligible for this relief. The relief granted by Notice 2002-23 applies only if the plan is required under Title I of ERISA to file an annual report.

The DFVC Program does not offer a means of requesting a waiver of penalties due to reasonable cause. If the administrator wants to argue reasonable cause, it must do so outside of this program. With the DFVC Program's penalties being so low, some administrators will have to weigh the two alternatives. The DFVC Program offers preset penalties and the certainty of no further sanctions, even from the IRS. A reasonable cause waiver request has the possibility of being denied, and the penalties that might be imposed if the request is denied are not known.

IRS PILOT PROGRAM FOR NON-ERISA PLANS

Late filed Forms 5500-EZ are not correctable under DFVC, because they are not filed with the DOL. Prior to 2014, a plan that is a Form 5500-EZ filer, or a plan that covers no employees [within the meaning of DOL Reg. §2510.3-3(b)

[95] Section 3.02 of the DFVC Program.
[96] Federal Register, Vol. 78, No. 19, RIN 1210–ZA15.
[97] Sections 3.04 and 4.04 of the DFVC Program.
[98] Notice 2002-23.
[99] Rev. Proc. 2013-12, §6.09.

and (c)], but is required to file Form 5500, rather than Form 5500-EZ, had no relief available for delinquent filings. The only option for such plans was to request reasonable cause relief from the IRS for any applicable penalties on a late Form 5500 or Form 5500-EZ.

Relief Provided to Non-ERISA Plans

Effective June 4, 2014, the IRS established a temporary pilot program providing administrative relief from the imposition of failure-to-timely-file penalties for Form 5500-EZ and similar filers that are exempt from Title I of ERISA. The program has since been updated and made permanent effective June 3, 2015.[100]

In contrast to the pilot program, which required no penalty or payment for relief, the 2015 update initiated a penalty structure. The payment for each submission is $500 for each delinquent return for each plan, up to a maximum of $1,500 per plan.

To qualify for the relief, a plan sponsor or administrator must file the late return and any required schedules and attachments. Only paper filings will be accepted. What must be filed depends on the year(s) involved and the type of plan. Unlike the DOL's delinquent filer program, the form for the actual plan year must be used (rather than a current year form). So, if the late filing involves a 2006 plan year, the filer must locate a 2006 Form 5500 series return. The IRS suggests www.irs.gov/retirement or http://www.dol.gov/ebsa/5500main.html as sources for prior year returns.

Plan sponsors or administrators that have received a CP 283 Notice, "Penalty Charged on Your 5500 Return," for a delinquent return do not qualify for relief under this program. Also, returns filed electronically through EFAST2 are ineligible for penalty relief under this program.

If You're Curious . . .

In order to file, the following steps must be taken:

- The filing must be submitted on paper.
- On each late return submitted, the top margin of the first page above the title of the form should contain the following statement in red letters: "Delinquent return submitted under Rev. Proc. 2015-32, Eligible for Penalty Relief."
- Each submission must include a completed paper copy of Form 14704 and the appropriate fee. It must be attached to the front of the oldest delinquent return in the submission. For example, if delinquent returns for 2010, 2011, and 2012 are included in the same submission, Form 14704 must be attached to the front of the 2010 return.
- Late filings, Form 14704 and the appropriate penalty should be mailed to the IRS at Internal Revenue Service, 1973 North Rulon White Blvd., Ogden, Utah 84404-0020.

Section 11.07: Audit Requirements

AUDIT BY INDEPENDENT QUALIFIED PUBLIC ACCOUNTANT

For any year in which the plan has large plan filing status, a written opinion of an independent qualified public accountant must accompany the report.[101] This is often referred to as the **audit requirement** and may be a significant additional expense of annual plan administration. For small plan filers, the audit requirement is waived if certain conditions are met.

[100] Rev. Proc. 2015-32.
[101] ERISA §103(a)(3).

Accountant's Report

The accountant's report must state whether the audit was made in accordance with generally accepted auditing standards and the opinion of the accountant regarding the financial statements and schedules covered by the report.[102]

The Employee Benefit Security Administration (EBSA), as part of its public education campaign regarding fiduciary responsibilities under ERISA, has published a short piece titled, "Selecting an Auditor For Your Employee Benefit Plan," which is available at the DOL website. In that publication, the DOL recommends that the employer make sure the auditor has considered the following areas:

- Whether plan assets covered by the audit have been fairly valued;
- Whether plan obligations are properly stated and described;
- Whether contributions to the plan were timely received;
- Whether benefit payments were made in accordance with plan terms;
- If applicable, whether participant accounts are fairly stated;
- Whether issues were identified that may impact the plan's tax status; and
- Whether any transactions prohibited under ERISA were properly identified.

Effect of Filing Status Exceptions

If a large plan's participant count drops below 100, but the employer elects to continue filing as a large plan filer, the accountant's report is still required.[103] This is one reason why some employers will begin filing as a small plan filer for the first plan year that the participant count drops below 100.

Form 5500-EZ Filer

A plan eligible to file Form 5500-EZ would not be subject to Title I of ERISA, so the audit requirement would not be applicable to such plan in any case.

Exception for Small Plan Filer

The audit requirement applies to a small plan filer, unless certain conditions are satisfied.[104] If a small plan filer fails to satisfy the audit waiver conditions (described below), it nonetheless still files as a small plan filer (e.g., Schedule I is still used, rather than Schedule H), but an accountant's report must accompany the Form 5500 filing.

The audit requirement is aimed at addressing the potential vulnerability of small pension plans to fraud and abuse. The DOL feels the rules increase the security of assets in small plans by conditioning the waiver of the audit requirement on enhanced disclosure of information to participants and beneficiaries, and where the plan invests more than 5 percent of its assets in nonqualifying plan assets, by improving the bonding requirements.

Conditions for Exemption from Audit Requirement

To be exempt from the audit requirement, a small pension benefit plan must satisfy the requirements described below. Note that this exemption from the audit requirement is not available to a large plan filer even if the conditions described below are satisfied.

- Investment/bonding requirement. At least 95 percent of the plan's assets must be invested in qualifying plan assets or, if the 95 percent requirement is not satisfied, the assets that are not qualifying plan assets must be covered by a bond that satisfies the requirements of ERISA §412 and is not less

[102] DOL Reg. §2520.103-1(a)(5).
[103] DOL Reg. §2520.104-46(d).
[104] DOL Reg. §§2520.104-41(c) and §2520.104-46(b)(1) and (d), 65 F.R. 62958 October 19, 2000).

than the value of such assets (without regard to the bonding limits under the normal ERISA bonding rules).

- Enhanced disclosure requirement. The summary annual report (SAR) (discussed later) must include additional information pertaining to the financial institutions involved in the holding or issuance of plan assets, and, if applicable, the surety company that issues the bonding necessary to comply with the additional bonding requirements.

If You're Curious . . .

Definition of Qualifying Plan Assets

Qualifying plan assets are investments described in any of the following six categories.

- Category #1: Qualifying employer securities.
- Category #2: Participant loans that satisfy the prohibited transaction exemption requirements under ERISA §408(b)(1).
- Category #3: Assets held by a regulated financial institution. A regulated financial institution is a bank, as defined in IRC §581; a domestic building and loan association, as defined in IRC §7701(a)(19); a credit union, as defined in section 101(6) of the Federal Credit Union Act; an insurance company; a registered broker-dealer; or any other organization that is authorized to act as a trustee of IRAs under IRC §408(a)(2).[105]

  Assets are held by a regulated financial institution if they are held by the institution in a trust, custodial account, brokerage account, or in any type of omnibus account structure. In Frequently Asked Questions on the Small Pension Plan Audit Waiver Regulation, as posted at the DOL website (www.dol.gov/ebsa/faqs/faq_auditwaiver.html), the DOL clarifies that qualifying plan assets include checking and savings accounts established by the plan with a regulated financial institution, but do not include a safe deposit box at a bank. For example, if a plan invests in coins, which it keeps in a safe deposit box, such coins are nonqualifying plan assets.
- Category #4: Shares issued by an investment company registered under the Investment Company Act of 1940 (i.e., a registered mutual fund).
- Category #5: Investments and annuity contracts issued by an insurance company qualified to do business under the laws of any state.
- Category #6: Assets in the individual account of a participant beneficiary over which the participant or beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished, at least annually, a statement from a regulated financial institution describing the assets held (or issued by) such institution.

The fact that a loan exceeds the limits under IRC §72(p) does not necessarily render the loan a nonqualifying asset. However, if the plan's loan policy expressly limits loans to the IRC §72(p) limits, and the loan exceeds those limits, the loan has failed to follow the terms of the plan and, thus, is not exempt from the prohibited transaction rules under ERISA §408(b)(1). Such a loan is not a qualifying asset. The DOL addresses this issue in the preamble to the regulations. The preamble also notes that a loan that has gone into default is a qualifying plan asset, as long as it satisfied the prohibited transaction exemption requirements at the time it was made.

The disclosures in the SAR would not have to include the individually-directed assets described in Category #6. Thus, a participant is not required to receive information in the SAR about the assets held in the individually-directed accounts of other participants.

[105] Treas. Reg. §1.408-2(e).

Determination of the Percentage of Qualifying Plan Assets

The determination of the percentage of assets that constitute qualifying plan assets is made at the beginning of the plan year, in accordance with the rules set forth in the bonding regulations, based on the information as of the last day of the preceding plan year [i.e., the information reported in the Form 5500 Schedule I filed for the prior plan year].[106] For the first plan year, the determination is made on the basis of an estimate.[107]

Assets Held in Participant-Directed Accounts

Some or all of the assets described in Category #6 might fall into other categories. What is significant about an asset falling into Category #6 is that the enhanced disclosure requirements in the SAR are not applicable with respect to the Category #6 assets. To fall into Category #6, the assets in a participant-directed account must be described in a statement received by the participant from the regulated financial institution which holds or issues such assets. In Frequently Asked Questions on the Small Pension Plan Audit Waiver Regulation, as posted at the DOL website (www.dol.gov/ebsa/faqs/faq_auditwaiver.html), the DOL clarifies that the institution's regular distribution systems may be used to transmit the statements to participants and beneficiaries. For example, a statement prepared on the institution's letterhead, which the participant could use to confirm the accuracy of the information with the financial institution, could be given to the plan administrator for distribution to participants and beneficiaries. If the plan administrator prepares the statement, this requirement is not satisfied even if the administrator's statement is based on data from the regulated financial institution.

EXAMPLE 11-14. Qualifying Plan Assets at Least 95 Percent of Total. A plan has the following assets as of December 31, 2017:

Various investments with banks, ins. co., mutual funds	$520,000
Qualifying employer securities	$40,000
Participant loans (exempt from prohibited transaction)	$20,000
Real estate limited partnerships	$20,000
Total assets	$600,000

In this case, the only asset that is not a qualifying plan asset is the real estate limited partnership, which is held in a safety deposit box in the name of the plan. That asset represents only 3.33 percent ($20,000/$600,000) of the total assets. Because at least 95 percent of the plan assets are held in qualifying plan assets, the audit exemption would continue to apply for the 2018 plan year, provided the disclosure requirements are satisfied. No additional bonding requirements would apply in order to obtain the audit exemption.

EXAMPLE 11-15. Qualifying Plan Assets Less Than 95 Percent of Total. A plan has the following assets as of December 31, 2017:

Various investments with banks, ins. co., mutual funds	$610,000
Qualifying employer securities	$65,000
Participant loans (exempt from prohibited transaction)	$29,000
Real estate limited partnerships held by individual trustees	$96,000
Total assets	$800,000

The qualifying plan assets total $704,000: the investments with banks, insurance companies and

[106] DOL Reg. §2580.412-14.
[107] DOL Reg. §2580.412-15.

mutual funds, qualifying employer securities, and participant loans. The nonqualifying assets are the plan's investments in real estate limited partnerships. In this case, the nonqualifying plan assets constitute 12 percent of the total ($96,000/$800,000). To obtain the audit exemption for the 2018 plan year, there must be a fidelity bond in an amount equal to at least $96,000 that covers the person(s) handling the nonqualifying plan assets.

EXAMPLE 11-16. Bank is Trustee of All Assets. Suppose in the prior **EXAMPLE 11-15** that the trustee is a bank that holds title to the limited partnership investments. Now 100 percent of the assets are qualifying plan assets because the limited partnership investments are held by a regulated financial institution. The audit exemption applies even if the special bonding requirement has not been met.

Normal Bonding Might be Sufficient

Even if a small plan is subject to the special bonding requirement because more than 5 percent of its assets are not in qualifying plan assets, an additional bond might not be necessary. The normal requirement is that the value of the bond be at least 10 percent of the plan's assets being handled (capped at $500,000 per plan or $1,000,000 if the plan contains employer securities).[108]

If a plan has a bond that covers the persons handling the nonqualifying assets and that bond is for an amount no less than the value of the nonqualifying assets, then this audit exemption requirement is still satisfied. Thus, in many cases the audit exemption conditions will not result in a greater bonding requirement unless the nonqualifying assets exceed 10 percent of plan assets.

However, the $500,000 (or $1,000,000) cap under the normal bonding rules is not applicable to the small plan audit rules. So, if 8 percent of the plan's assets are nonqualifying assets, a bond covering the entire value of those assets would be necessary even if the value exceeds the $500,000 (or $1,000,000, as applicable) limit under normal bonding rules.

The plan must be named in the bond as an insured, the bond may not include a deductible or similar feature, and the bonding company must be on the Treasury Department's Circular 570 list of approved surety companies. This list may be obtained at www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570_a-z.htm.

Enhanced Disclosure Requirements in the SAR

For the audit waiver to be available, the plan's SAR must include the following enhanced disclosure requirements:

- The name of each regulated financial institution holding or issuing qualifying plan assets and the amount of such assets reported by the institution as of the end of the plan year, except as described below;
- The name of each surety company issuing enhanced fidelity bonding (i.e., if the plan has more than 5 percent of its assets in nonqualifying plan assets);
- A notice of the participant's right to examine or receive without charge copies of evidence of the required bond from the plan, copies of statements from the regulated financial institution describing qualifying plan assets and a notice that EBSA should be contacted if a participant or beneficiary is unable to make such an examination or obtain such copies.

If a request described in the third bullet is received, the plan administrator must provide the requested documents, or the exemption from the audit requirement is not applicable.

No enhanced SAR disclosures apply to qualifying plan assets that are qualifying employer securities, participant loans

[108] ERISA §412.

or any assets held in a participant-directed account with respect to which the participant or beneficiary is furnished the required statement from a regulated financial institution (i.e., Categories #1, #2 and #6, as identified above).

The DOL has provided, as part of *Frequently Asked Questions on the Small Pension Plan Audit Waiver Regulation* posted at its website, an example of language that could be included in an SAR to satisfy the enhanced disclosures.

Independence of Accountant

The accountant performing the audit must be independent of the plan.[109] As a general rule, an accountant would not be independent of the plan if the accountant is a service provider, fiduciary or participant in the plan. The accountant also must be independent of the plan sponsor. This means the accountant does not have a financial interest in the plan sponsor and is not an employee of the plan sponsor.

No-Opinion Audit Not Acceptable

A no-opinion audit is the same as no audit and the Form 5500 filing would be incomplete.[110] If the DOL rejects the filing, and a revised filing is not submitted within 45 days, the DOL may retain an accountant to perform the audit. Penalties for failure to file could apply, too.

If You're Curious . . .

Exception When Short Plan Year Created

An exception to filing the accountant's report is available when there is a plan year that is seven or fewer months in length if the short plan year is the result of any of the following events:

- Establishment of the plan;
- Merger with another plan;
- Amendment to the plan year; or
- Termination of the plan.

In such a case, the plan is excused from including the accountant's report with the Form 5500 filed for the first of two consecutive plan years that include the short plan year.[111] It does not matter whether the short plan year is the first plan year or the second plan year. The Form 5500 filed for the second of the two plan years must include the accountant's report that covers both plan years. This exception saves the plan the expense associated with a separate audit report for both years.

EXAMPLE 11-17. Auditing Exception for Short Plan Year. A corporation maintains a 401(k) plan with a plan year ending June 30. Effective January 1, 2018, the plan year is changed to the calendar year, creating a short plan year running from July 1, 2017, to December 31, 2017. Because the short plan year is six months long (i.e., seven or fewer months long), the corporation is eligible for this exception. It may elect not to include the accountant's report with the Form 5500 filed for the short plan year, if the accountant's report included with the Form 5500 filed for the 2018 plan year covers the period July 1, 2017, through December 31, 2018. In this example, the corporation would be treating the short plan year as the first plan year and the 2018 calendar year as the second plan year in the two consecutive year period.

Alternatively, the employer may elect to treat the two-year period as the 12-month plan year

[109] DOL Interpretive Bulletin 75-9 (DOL Reg. §2509.75-9).
[110] DOL Advisory Opinion 84-45A.
[111] DOL Reg. §2520.104-50.

ending June 30, 2017, and the short plan year ending December 31, 2017. In that case, the first year would be the year ending June 30, 2017, and no accountant's report would be filed for that year. The second year would be the short plan year and the accountant's report filed with the Form 5500 for the short year would cover the period from July 1, 2016, through December 31, 2017.

Exemption from Audit for Certain Fully Insured and Unfunded Arrangements

DOL regulations provide audit exemptions for certain fully insured pension plans.[112] A pension plan is exempt from the audit requirement if the benefits are funded exclusively with allocated insurance contracts.[113] The premiums, to the extent paid by participant contributions, must be forwarded by the employer to the insurer within three months after receipt. The regulation also exempts certain insured or unfunded welfare benefit plans from audit.

STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS (SSAE)

To facilitate the work that must be performed in order to issue the opinion that accompanies the Form 5500 filing, independent qualified public accountants often rely on service provider audit reports. The audit report assesses the internal controls that exist in service organizations [such as third party administrators (TPAs) or firms providing daily valuation recordkeeping] to help ensure that the controls result in accurate, quality service being provided to the plan, its sponsor and its participants. For nearly 20 years, a Statement of Accounting Standards (SAS) 70 was commonly used for this purpose.

Effective for reporting on periods ending on or after June 15, 2011, SAS 70 was replaced by new standards. The requirements for reporting on controls at service organizations have been placed in Statement on Standards for Attestation Engagements (SSAE) No. 16. In accordance with SSAE No. 16, Service Organization Control (SOC) 1 engagements are performed and SOC 1 reports address controls at a service organization that are likely to be relevant to an audit of a user entity's financial statements.

Although service organizations are not required to obtain an SOC 1 report, the report is an effective means of distributing the cost of auditing retirement plans and may be marketed as a value-added service for its clients. This is because the plan auditor may rely upon the SOC 1 report to determine whether operations are properly performed for the plan by the service provider.

Why is an SOC 1 Report Needed?

A retirement plan's internal controls are generally not limited to the controls in place within the plan sponsor's physical facility or internal operations. Commonly, plans use other organizations to perform services that affect the plan's ability to record, process, summarize and report financial information in its financial statements. These service providers, for plan auditing purposes, are known as service organizations.

Common examples of service organizations include bank trust departments, insurance companies and retirement plan administration firms. Service organizations may provide a wide range of services to an employee benefit plan. The trust department of a bank, for instance, could be given authority to make decisions about how a plan's assets are invested. It also may serve as custodian of the plan's assets, maintain records of each participant's account, allocate investment income to the participants

[112] DOL Reg. §2520.104-44(b).
[113] DOL Reg. §2520.104-44(b)(2).

as directed by the plan document, make distributions to participants and prepare filings for the plan, such as the Form 5500 or Form 1099-R. If a retirement plan chooses to have the service organization perform some or all of these tasks, the service organization might be executing, recording and maintaining the documentation for that portion of the plan's transactions. This activity could have a material effect on the plan's financial statements.

When a plan sponsor engages a service organization, transactions that affect the plan's financial statements are subjected to controls that may be physically and operationally removed from the plan sponsor. In effect, the plan sponsor shifts some control procedures to the service organization and must consider the service organization's control procedures as part of its overall internal control environment for the plan.

In the end, the independent qualified public accountant that is planning and performing the audit of the retirement plan must gain an understanding of the plan's control environment, including the controls at the service organization. The SOC 1 report, together with other information about the plan sponsor, helps the plan's auditor understand the aspects of the service organization's controls that may affect the processing of the plan's transactions and the flow of significant transactions through the service organization. In addition, the plan auditor is able to determine whether the service organization's controls are suitably designed to prevent or detect processing errors that could result in a material misstatement of the plan's financial statements.

Who Obtains an SOC 1 Report?

A retirement plan administration firm that has its own in-house daily valuation operation is considered a "service organization" and may engage an independent qualified public accountant to perform an SOC 1 engagement. Those firms providing daily valuation through subcontractors or other alliances should expect the alliance partner to have its own SOC 1 engagement performed. It is important for an administration firm operating in a daily environment to have the SOC 1 report because the service provider initiates most of the transactions automatically.

A TPA firm that is directly involved in processing transactions and placing trades such as in daily valuation recordkeeping is likely to engage an independent qualified public accountant to perform an SOC 1 engagement. In contrast, balance-forward retirement plan administration firms generally do not initiate an SOC 1 engagement because the plan sponsor is usually directly involved in processing all transactions.

A service auditor may issue two types of reports under SSAE No. 16; type 1 and type 2. The user auditor generally will request to receive a type 2 report.

What is an SOC 1 Type 1 Report?

In an SOC 1 type 1 report, the service auditor expresses an opinion on whether the service organization's description of its controls is fairly presented (that is, whether it describes what actually exists) and whether the controls included in the description are suitability designed. Controls that are suitably designed are able to achieve the related control objectives if they operate effectively.

EXAMPLE 11-18. Type 1 Report. A profit sharing plan uses a bank trust department to invest and service the plan's assets. When the profit sharing plan's financial statements are audited, the independent qualified public accountant needs information about the plan's internal control over financial reporting, including controls at the bank trust department that affect the plan's financial statements. To help the accountant obtain that information, a separate service auditor performs an examination of controls at the bank trust department resulting in a report with detailed information about those controls. The service auditor's SOC 1 type 1 report includes

opinions on whether the description of the bank trust department's system is fairly presented and whether controls at the bank trust department that may affect user entities' financial reporting are suitably designed.

What is a Soc 1 Type 2 Report?

In an SOC 1 type 2 report, the service auditor's report contains the same opinions as those in a type 1 report, but also includes an opinion on whether the controls are operating effectively. Controls that operate effectively achieve the control objectives they were intended to achieve. A type 2 report also includes a description of the service auditor's tests of operating effectiveness and the results of those tests so that user auditors can determine how the results of the service auditor's tests affect a particular user entity.

EXAMPLE 11-19. Type 2 Report. Suppose in **EXAMPLE 11-18** that the service auditor was asked to provide a type 2 report. The service auditor's type 2 report will still include opinions on whether the description of the bank trust department's system is fairly presented and whether controls at the bank trust department that may affect user entities' financial reporting are suitably designed. In addition, the type 2 report will include the service auditor's opinion as to whether the bank trust department's controls were operating effectively, with a description of the tests that were performed by the service auditor in order to form that opinion and the results of those tests.

Section 11.08: Summary Annual Reports

A plan is required by ERISA to furnish each participant and each beneficiary receiving benefits with a summary of the plan's financial position.[114] This is known as the **summary annual report** (SAR), because it summarizes the information on the plan's annual report (Form 5500) filed with the government. The Form 5500 filing contains this information, but providing a copy of the form to participants will not satisfy the SAR requirement.

Companies that maintain an intranet website for the purposes of communicating with employees, and not the public, must display the Form 5500 information on that website. This rule is effective for plan years beginning in 2008 and later.[115]

The SAR requirement has been repealed for defined benefit pension plans, effective for plan years beginning in 2008 and later.[116] A different annual notice relating to plan funding has replaced the SAR for those plans.

CONTENT OF THE SAR

The DOL has provided sample SARs to be used by qualified plans and by welfare plans.[117] Most plans use the samples to comply with this requirement. The SAR for a qualified plan will include the total administrative expenses incurred by the plan, the amount of benefits paid to participants and beneficiaries and the total value of the plan assets.

If the plan is subject to minimum funding standards (i.e., target benefit or money purchase pension plan), a statement about compliance with those standards must be included. If a plan subject to minimum funding standards is waiving an audit requirement, certain information must be disclosed in the SAR as described in the second bullet in previous section 11.07 [A]4(a).

[114] ERISA §104(b)(3).
[115] ERISA §104(b)(5).
[116] ERISA §104(b)(3), as amended by PPA §503(c).
[117] DOL Reg. §§2520.104b-10(d)(3), 2520.104b-10(d)(4).

The SAR must also inform the participant or beneficiary of his or her right to receive a copy of the applicable Form 5500 filing.

WHEN TO PROVIDE THE SAR

The SAR for a plan year must be furnished by not later than nine months after the close of the plan year.[118] This deadline provides the plan administrator an additional two months after Form 5500 is filed to prepare and distribute the SAR. If the Form 5500 filing is extended, the SAR is due two months after the extended due date.[119]

ENFORCEMENT OF SAR REQUIREMENT

ERISA does not impose civil penalties on a plan administrator for failure to comply with the SAR requirements.

Section 11.09: Review of Key Concepts

- What is Title I of ERISA?
- Which employers are/are not subject to Title I?
- What types of plans are required to file Form 5500?
- Describe the difference among large plan filers, small plan filers and those eligible for Form 5500-EZ or Form 5500-SF filing.
- What are the different filing requirements based on filing status?
- Describe each of the Form 5500 schedules and various attachments.
- Explain the purpose and filing requirements of Form 8955-SSA.
- What is the small plan audit waiver?
- Describe the requirements, including disclosure and bonding, required for the small plan audit waiver.
- Describe the normal fidelity bonding requirements.
- When is Form 5500 due?
- How are the Form 5500 deadlines affected by short plan years or a plan termination?
- What are the consequences for failing to satisfy the Form 5500 filing requirements?
- What items are covered in an accountant's report?
- Describe an SAR and the requirements of disclosure.

Section 11.10: For Practice – True or False

1. When a plan year coincides with the employer's tax year and the employer has an extension for filing their federal income tax return, the Form 5500 filing for the plan is automatically extended to the same date.
2. A plan whose only participants are the sole owner of the business and the owner's child may be eligible to file Form 5500-EZ.
3. An owner-employee who sponsors a defined benefit plan and a profit sharing plan, and is the only participant, must file Form 5500-EZ for each plan if the combined assets of both plans exceed $250,000.
4. Form 5500 is filed with EBSA and Form 5558 is filed with the IRS.
5. The IRS is the only agency that can impose penalties for Form 5500 noncompliance.

[118] DOL Reg. §2520.104b-10(c).
[119] DOL Reg. §2520.104b-10(c)(2).

6. Only large plan filers need to file an accountant's report with Form 5500.
7. A small plan filer with 115 participants at the beginning of the plan year must file as a large plan filer for that year.
8. The filing deadline for Form 5500, without extension, is the last day of the seventh month following the end of the plan year.
9. The DFVC Program may be used by late filers of Form 5500 to significantly reduce the penalties for noncompliance.
10. Small plan filers may be exempt from the audit requirement.

Section 11.11: Sample Test Questions

1. Which of the following is/are situations in which participants need not be reported on Form 8955-SSA?
    - I. If benefit payments have commenced before the participant was reported on Form 8955-SSA
    - II. If a participant previously reported with deferred vested benefits on Form 8955-SSA now commences benefits
    - III. If the participant has returned to covered service before the participant was reported on Form 8955-SSA

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

2. All of the following statements regarding Form 5500 schedules are TRUE, EXCEPT:
    A. Large plan filers use Schedule H to report certain financial information about the plan.
    B. Schedule C is used to report service provider information.
    C. Schedule A is used to report insurance information.
    D. Schedule D is used to report actuarial information.
    E. Prohibited transactions are one of the items reported on Schedule G.

3. All of the following statements regarding Form 5500 filing deadlines are TRUE, EXCEPT:
    A. A plan year ends December 31, 2017. Form 5500, without extension, is due July 31, 2018.
    B. A terminated plan distributed the plan assets on October 6, 2017. Form 5500, without extension, is due May 6, 2018.
    C. A plan year ends November 30, 2017. Form 5500, with extension, is due September 15, 2018.
    D. A short plan year runs from June 1, 2017, to August 31, 2017. Form 5500, with extension, is due June 15, 2018.
    E. A plan year ends March 31, 2018. Form 5500, without extension, is due October 31, 2018.

4. All of the following statements regarding the small plan audit exemption are TRUE, EXCEPT:
    A. A small plan filer that does not satisfy the audit exemption files as a large plan filer, including an accountant's report and Schedule H with the filing.
    B. A small plan filer with 98 percent of assets invested in qualifying assets may be exempt from the audit requirement.
    C. A small plan filer with 90 percent of assets invested in qualifying assets and a fidelity bond for the remaining ten percent of nonqualifying assets may be exempt from the audit requirement.

D. Employer securities are considered qualifying plan assets when determining if the small plan audit exemption applies.
E. The percentage of assets that are qualifying plan assets is determined at the beginning of the plan year.

5. Which of the following is/are exempt from Title 1 Form 5500 reporting requirements?

   I. SEP
   II. SIMPLE IRA
   III. Governmental plan

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

6. All of the following statements regarding Form 5500 penalties are TRUE, EXCEPT:

   A. The DOL has the authority to impose significant penalties for failure to file Form 5500.
   B. The IRS has the authority to impose significant penalties for failure to file Form 5500.
   C. The DOL may not impose a penalty for missing items, like an accountant's report, if the Form 5500 filing is timely.
   D. Under the DFVC Program, plan sponsors may voluntarily file late returns in exchange for a significantly reduced late filing penalty.
   E. If the plan is a small plan filer, the maximum penalty under the DFVC Program for a single late Form 5500 is $750.

7. Which of the following statements regarding Form 5500 audits is/are TRUE?

   I. The audit exemption may be available to large plan filers if the participant count drops below 100.
   II. Auditors should investigate whether contributions to the plan were made in a timely manner.
   III. An accountant would not be considered independent of the plan if the accountant is a service provider.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

8. All of the following statements regarding Form 5500 filings are TRUE, EXCEPT:

   A. In most cases, no schedules are required to be filed with Form 5500-SF.
   B. A one-participant owner plan with $500,000 of plan assets is not required to file Form 5500-EZ.
   C. A plan that covers the business owner and one employee is not eligible to file Form 5500-EZ.
   D. A non-ERISA 403(b) plan that satisfies the DOL exception is not required to file Form 5500.
   E. Generally, a large plan filer for Form 5500 purposes is a plan with more than 100 participants on the first day of the plan year.

9. All of the following statements regarding the DFVC Program are TRUE, EXCEPT:

   A. The penalty under the DFVC Program may be paid from plan assets.
   B. If more than one plan is involved, a separate DFVC submission must be made for each plan.

C. A completed Form 5500 must be filed for each plan year for which DFVC relief is sought.
D. IRS penalties for a late filing of Form 5500 are automatically waived for a plan that participates in the DFVC Program.
E. The DFVC Program has a per-plan cap, which provides a maximum penalty for plans that have failed to file for multiple years.

10. Which of the following statements regarding fidelity bonds is/are TRUE?

    I. Plan assets may not be used to purchase the fidelity bond.
    II. The minimum required bond amount is $1,000, even if this exceeds 10 percent of the amount of funds being handled.
    III. The maximum required bond amount is $500,000 for plans that hold employer securities.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

Section 11.12: Solutions to True or False Questions

1. True.
2. False. A one-participant plan, eligible to file Form 5500-EZ, is a plan that includes the owner of the business and their spouse. If a child is a participant, the plan is no longer eligible for Form 5500-EZ filing status.
3. True.
4. True.
5. False. Both the IRS and the DOL can impose penalties for Form 5500 noncompliance.
6. False. A small plan filer is only exempt from the audit requirement if it satisfies the investment, bonding and disclosure requirements regarding qualifying plan assets.
7. False. A small plan filer need not file as a large plan filer until the plan has more than 120 participants at the beginning of the plan year.
8. True.
9. True.
10. True.

Section 11.13: Solutions to Sample Test Questions

1. The answer is **C**. A participant previously reported with deferred vested benefits on Form 8955-SSA must again be reported when the participant commences benefits.
2. The answer is **D**. Actuarial information is reported on Schedule SB or Schedule MB. DFE information is reported on Schedule D.
3. The answer is **B**. The filing deadline, without extension, is the last day of the seventh month following the distribution of assets, or May 31, 2018.
4. The answer is **A**. A small plan filer that does not satisfy the audit exemption still files as a small plan filer, including an accountant's report with Schedule I, rather than Schedule H.
5. The answer is **E**. All of the plan types listed are generally exempt from Title I Form 5500 reporting.
6. The answer is **C**. The DOL may impose a penalty for missing items, like an accountant's report, even if the Form 5500 filing is timely.
7. The answer is **D**. If a large plan's participant count drops below 100, but the employer elects to continue filing as a large plan filer, the accountant's report is still required.
8. The answer is **B**. A one-participant owner plan with assets over $250,000 is required to file Form 5500-EZ.
9. The answer is **A**. The penalty under the DFVC Program is a personal liability of the plan administrator and, thus, may not be paid from plan assets. Payment of the penalty with plan assets would constitute a prohibited transaction and also would violate the exclusive benefit rule.
10. The answer is **B**. Plan assets may be used to purchase the fidelity bond. The maximum required bond amount is $500,000 for plans that hold no employer securities and up to $1 million for plans that hold employer securities.

Chapter 12:
Code of Professional Conduct

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Section 12.01: Code of Professional Conduct

The purpose of this Code of Professional Conduct ("Code") is to identify the professional and ethical standards with which a Member must comply, in order to fulfill the Member's responsibility to the American Retirement Association and its affiliate organizations, other Members, and the public. Members are required to adhere to the high standards of conduct, practice, and qualification set forth in this Code.

Definitions

- Actuary: an individual who is a Member of the American Retirement Association and holds an MSPA or FSPA from the ASPPA College of Pension Actuaries or an actuarial credential from another organization that is a member of the International Actuarial Association (IAA) or is an enrolled actuary in good standing with the Joint Board for the Enrollment of Actuaries.
- Advertising: all communications by whatever medium, including oral communications, which may directly or indirectly influence any person or organization to decide whether there is a need for Professional Services or to select a specific person or firm to perform such services.
- Confidential Information: information not in the public domain of which the Member becomes aware during the course of rendering Professional Services to a Principal. It may include information of a proprietary nature, information which is legally restricted from circulation, or information which the Member has reason to believe that the Principal would not wish to be divulged.
- Credential: a membership designation (e.g., Certified Pension Consultant; Member, Society of Pension Actuaries; or Associated Professional Member) conferred by American Retirement Association.
- Law: statutes, regulations, judicial decisions, and other statements having legally binding authority.
- Member: An individual who is a Member of American Retirement Association or any affiliate organization of American Retirement Association.
- Principal: any present or prospective client of a Member or the employer of a Member where the Member provides retirement plan services for their employer's plan.
- Professional Communication: a written, electronic or oral communication issued by a Member with respect to Professional Services.
- Professional Services: services provided to a Principal by a Member, including the rendering of advice, recommendations, findings, or opinions related to a retirement or other employee benefit plan.
- Titles: leadership positions, volunteer experience, awards and other honors conferred by American Retirement Association.

Advertising

A Member shall not engage in any Advertising with respect to Professional Services that the Member knows or is reasonably expected to know are false.

Communications

A Member who issues a Professional Communication shall take appropriate steps to ensure that the Professional Communication is appropriate to the circumstances and its intended audience.

Compliance

A Member shall be knowledgeable about this Code, keep current with Code revisions and abide by its provisions. Laws may impose binding obligations on a Member. This Code is not intended to supplant, contradict or supersede Law (e.g., Circular 230) or other Codes of Conduct that establish professional standards for Members in the rendition of Professional Services and that have been sanctioned by the federal or a state government. Where the requirements of

Law or such governmentally-sanctioned Codes conflict with this Code, the requirements of Law or such governmentally-sanctioned Codes take precedence.

Confidentiality

A Member shall not disclose to another party any Confidential Information obtained in rendering Professional Services for a Principal unless authorized to do so by the Principal or required to do so by Law.

Conflicts of Interest

A Member shall not perform Professional Services involving an actual conflict of interest unless:

- The Member's ability to act fairly is unimpaired; and
- There has been full disclosure of the conflict to the Principal(s); and
- All Principals have expressly agreed to the performance of the services by the Member.

If the Member is aware of any significant conflict between the interests of a Principal and the interests of another party, the Member should advise the Principal of the conflict and include appropriate qualifications or disclosures in any related communication.

Control of Work Product

A Member shall not perform Professional Services when the Member has reason to believe that they may be altered in a material way or may be used to violate or evade the Law. The Member should recognize the risk that materials prepared by the Member could be misquoted, misinterpreted or otherwise misused by another party to influence the actions of a third party and should take reasonable steps to ensure that the material is presented fairly and that the sources of the material are identified.

Courtesy and Cooperation

A Member shall perform Professional Services with courtesy and shall cooperate with others in the Principal's interest. A Principal has an indisputable right to choose a professional advisor. A Member may provide service to any Principal who requests it even though such Principal is being or has been served by another professional in the same manner.

When a Principal has given consent for a new or additional professional to consult with a Member with respect to a matter for which the Member is providing or has provided Professional Services, the Member shall cooperate in assembling and transmitting pertinent data and documents, subject to receiving reasonable compensation for the work required to do so. In accordance with Circular 230, the Member shall promptly, at the request of the Principal, return any and all records of the Principal that are necessary for the Principal to comply with federal tax Law, even if the Member is not subject to Circular 230. The existence of a fee dispute generally does not relieve the Member of this responsibility except to the extent permitted by applicable state Law. The Member need not provide any items of a proprietary nature or work product for which the Member has not been compensated.

Disclosure

A Member shall make full and timely disclosure to a present or prospective Principal of all sources of direct or indirect material compensation or other material consideration that the Member or the Member's firm has received or may receive in relation to an assignment for such Principal. The disclosure of sources of material compensation or consideration that the Member's firm has received, or may receive, is limited to those sources known to, or reasonably ascertainable by, the Member.

Professional Integrity

A Member shall perform Professional Services, and shall take reasonable steps to ensure that Professional Services rendered under the Member's supervision are performed, with honesty, integrity, skill and care. A Member has an obligation to observe standards of professional conduct in the course of providing advice, recommendations and other services performed for a Principal. A Member who pleads guilty to or is found guilty of any misdemeanor related to financial matters or any felony shall be presumed to have contravened this Code and shall be subject to American Retirement Association's counseling and disciplinary procedures.

Qualification Standards

A Member shall render opinions or advice, or perform Professional Services, only when qualified to do so based on education, training and experience.

Titles and Credentials

A Member shall make truthful use of the membership Titles and Credentials of ARA to which the Member is entitled, and only where that use conforms to the practices authorized by American Retirement Association. A Member who is not an Actuary as defined in section 1 of this Code shall not professionally represent to the public to be an actuary or knowingly allow such misrepresentation by others.

Additional Obligations

A Member whose professional conduct is regulated by another membership organization shall abide by the professional Code of Conduct (or similar rules) of such organization. For example, a Member who is an actuary shall also abide by the Code of Professional Conduct for actuaries.

A Member shall respond promptly in writing to any communication received from a person duly authorized by American Retirement Association to obtain information or assistance regarding a Member's possible violation of this Code. The Member's responsibility to respond shall be subject to Section 5 of this Code, "Confidentiality," and any other confidentiality requirements imposed by Law. In the absence of a full and timely response, American Retirement Association may resolve such possible violations based on available information.

Section 12.02: For Practice – True or False

1. Where the requirements of law or regulation conflict with the ARA Code of Professional Conduct, the ARA Code of Professional Conduct takes precedence.
2. ARA members should only perform professional services when qualified to do so based on education, training or experience.
3. An ARA member may be subject to discipline if found guilty of any misdemeanor or any felony.
4. Precautions should be taken to ensure that professional communications are appropriate to the circumstances and the intended audience.
5. The ARA Code of Professional Conduct must be prominently displayed in the offices of an ARA member.
6. An ARA member may not perform professional services if the member has reason to believe that the services may be used to evade the law.
7. Working for clients with conflicting interests is not permissible even if full disclosure is made and both clients are willing to continue the relationship.
8. If there is reason to believe that a principal would not want information to be divulged, it should be treated as confidential information.

9. It is not permissible for an ARA member to provide services to a principal who is currently being served by another benefits professional in the same matter.
10. Professional services should always be performed with honesty, integrity, skill and care.

Section 12.03: Sample Test Questions

1. Which of the following statements regarding ARA's Code of Professional Conduct is/are TRUE?

    I. False advertising with respect to professional services violates ARA's Code of Professional Conduct.
    II. An ARA member must disclose to a client all sources of compensation received with respect to services performed for such client.
    III. An ARA member may use ARA's membership titles and credentials only as permitted by ARA's Code of Professional Conduct.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

2. All of the following actions are acceptable in accordance with the ARA Code of Professional Conduct, EXCEPT:

    A. Recommending that the client change the eligibility provisions in a plan that is administered by another firm
    B. Reviewing the fee structure of another third party administrative firm with the client
    C. Discussing with one client the fees paid by another client that the ARA member services
    D. Offering to review the provisions of a client's qualified plan that is administered by another firm
    E. Releasing account information to a participant's spouse with written permission from the participant

3. Which of the following actions is/are violations of the ARA Code of Professional Conduct?

    I. Being convicted of a misdemeanor due to simple assault
    II. Being convicted of felony charges of driving while intoxicated
    III. Performing a distribution calculation in a careless manner without gathering sufficient information

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

4. Which of the following actions is/are acceptable in accordance with the ARA Code of Professional Conduct?

    I. Working for clients with conflicting interests if full disclosure is made and both clients agree to continue the relationship
    II. Providing a plan document to a client after December 31, knowing that the client intends to back date the document
    III. Releasing account information to a participant's attorney without the participant's consent

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

5. Which of the following actions is/are violations of the ARA Code of Professional Conduct?
    I. Using your QKA designation on your business card after failing to satisfy ARA's continuing education requirements
    II. Submitting a client's Form 8955-SSA on the due date without acknowledging a filing error warning received from the FIRE system
    III. Telling a potential client that you have experience working with new comparability plans when you have never worked on an new comparability plan

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

Section 12.04: Solutions to True or False Questions

1. False. Where the requirements of law or regulation conflict with this Code, the requirements of law or regulation take precedence.
2. True.
3. False. Disciplinary action may be taken for any felony, but only financially-related misdemeanors are subject to ARA's counseling and disciplinary procedures.
4. True.
5. False. The ARA Code of Professional Conduct need not be displayed in the offices of an ARA member.
6. True.
7. False. Performing professional services involving a conflict of interest may be permissible if the ARA member's ability to act fairly is unimpaired, the conflict has been fully disclosed to the principals and all principals have expressly agreed to the performance of the services by the ARA member.
8. True.
9. False. A member may provide service to any principal who requests it even if the principal is being or has been served by another benefits professional in the same matter.
10. True.

Section 12.05: Solutions to Sample Test Questions

1. The answer is **E**. All of the statements are true.
2. The answer is **C**. Discussing with one client the fees paid by another client that the ARA member services is a violation of confidentiality. "Confidential Information" refers to information not in the public domain of which the member becomes aware during the course of rendering professional services to a principal.
3. The answer is **D**. While being convicted of a misdemeanor due to simple assault is undesirable, it is not a financially-related misdemeanor and is not a violation of the ARA Code of Professional Conduct.
4. The answer is **A**. Providing a plan document to a client after December 31, knowing that the client intends to back date the document is violates the "control of work product" section of the ARA Code of Professional Conduct. Releasing account information to a participant's attorney without the participant's consent is a violation of confidentiality. Consent should be obtained before releasing confidential information.
5. The answer is **E**. All are violations of ARA's Code of Professional Conduct.

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