DC-3 STUDY GUIDE

ADVANCED COMPLIANCE AND ADMINISTRATION TOPICS

9TH EDITION

AMERICAN RETIREMENT ASSOCIATION

Working for America's Retirement

DEFINED CONTRIBUTION PLAN SERIES, VOLUME 3

The ASPPA Defined
Contribution Plan Series, Volume 3

ADVANCED COMPLIANCE AND ADMINISTRATION TOPICS

9th Edition

Excerpts taken from *The ERISA Outline Book*
By Sal L. Tripodi, J.D., LL.M.

AMERICAN
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Working for America's Retirement

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

AMERICAN RETIREMENT ASSOCIATION

Working for America's Retirement

4401 North Fairfax Drive, Suite 600
Arlington, VA 22203
703.516.9300
rpa@usaretirement.org
https://www.asppa.org/

9th 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-3 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.

CHAPTER 1:

PLANS COVERING MORE THAN ONE EMPLOYER AND LEASED EMPLOYEES

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1.01: Key Terms

- Leased employee
- Leasing organization
- Leasing organization safe harbor plan
- Multiemployer plan
- Multiple employer plan
- Primary direction or control
- Recipient

1.02: Introduction

Single-employer plans are the most common types of retirement programs. However, it is not uncommon for more than one company to join together to form a multiple employer or multiemployer plan. This chapter will discuss the issues involved when more than one company maintains and participates in a plan.

Over the years, many business structures have been developed with a goal of easing the administrative burden of maintaining employees. One of the reasons for these structures was the attempt to avoid covering certain workers in retirement and other benefit plans. One such structure involves leased employees.

Under this structure, a company (called a **leasing organization**) employs individuals and then leases the services provided by these individuals to various other companies (known as **recipient organizations** or **recipients**), such as doctors' offices, law firms and other businesses. The leased individuals work at the recipient organization in the same way that the recipient organizations' employees work for their employer. In fact, it was common for the recipient organization to "fire" the recipient organizations' employees, have them become employees of the leasing organization, and then the recipient organization would lease the same individuals as leased employees from the leasing organization. These workers were no longer considered employees of the recipient organization. As a result, the nurses or paralegals or other office workers would be excluded from a plan sponsored by the recipient organization, which could then provide significant benefits for its owners and executives without worrying about nondiscrimination rules.

In this chapter, we will discuss how Congress has legislated rules that make the leasing organization structure considerably less attractive if the goal is to avoid providing retirement benefits to workers. Nonetheless, leasing organizations continue to exist, and it is important to know the appropriate way to treat the leased employees in a given situation for retirement plan purposes.

1.03: Plans Covering More Than One Employer

It is possible to have more than one employer participating in one plan. Sometimes the employers are related to each other. In that case, the plan may be considered to be a single-employer plan, because the companies are considered to be one employer for qualified plan purposes. If the employers are not sufficiently related to each other, the plan may be a multiple employer plan (MEP). If the covered employees are unionized, the plan may be a multiemployer plan.

MULTIPLE EMPLOYER PLAN

A **multiple employer plan** (MEP) is a plan that is adopted by two or more employers where at least two of the participating employers are not members of the same related group (i.e., a controlled group or affiliated service group under Internal Revenue Code (IRC) §§414(b), (c), (m) or (o)) (see Chapter 3). The rules in IRC §413(c) apply to multiple employer plans. Additionally, ERISA requires that the plan be maintained by a bona fide group or association of employers.[1] During the first decade of the 21st century a number of so-called “open MEPs” were established. The term “open MEP” refers to a plan maintained by employers that do not have a common bond. “Open MEPs” are treated differently than traditional MEPs when preparing the Form 5500 and annual plan audit (to be discussed below).

Participating Employers Treated as Single-Employer for Certain Purposes

IRC §413(c) allows the participating employers in a multiple employer plan to be treated as a single-employer for certain purposes, even though these employers are not related under any of the related employer definitions under IRC §§414(b), (c), (m) or (o).

Eligibility

The plan must apply the minimum age and service requirements under IRC §410(a) as if all participating employers constitute a single-employer. Therefore, service with all of the participating employers is counted in determining an employee’s eligibility to participate in the plan.[2]

Exclusive Benefit Rule

The exclusive benefit rule is applied as if the employers are a single-employer. This permits the allocation of contributions and forfeitures across company lines without violating the rule that an employer’s contributions must be made for the benefit of its employees and former employees.[3]

Vesting

Unrelated participating employers are treated as if they together constitute a single-employer for vesting purposes. Therefore, service with all of the participating employers is counted in determining an employee’s position on the vesting schedule. Special break in service rules apply under regulations prescribed by the Secretary of Labor within the Department of Labor (DOL).[4]

IRC §415 Limits

When applying the IRC §415 limits to participant’s accounts in a multiple employer plan, benefits, contributions and compensation from all of the employers participating in the plan must be taken into account. For example, in a multiple employer plan that is a defined contribution plan,

[1] DOL Advisory Opinions 2003-17A, 2001-04A, 96-25A, 2012-04A and ERISA Sec. 3(5).
[2] IRC §413(c)(1).
[3] IRC §413(c)(2).
[4] IRC §413(c)(3). DOL Regulation 29 CFR 2530.201(f) and (g).

compensation from all of the participating employers is aggregated to determine the participant's IRC §415(c) limit. Then, the annual additions in the plan, with respect to all of the participating employers, are aggregated to determine if that limit is exceeded.[5] If the employers had maintained separate plans, this rule may not apply, and the IRC §415 limits would be separately determined for each employer because they are not part of a related group.

Form 5500 Filing

Only one Form 5500 and audit, if applicable, is filed for a multiple employer plan each year, regardless of the number of participating employers. However, an attachment must be included that generally identifies each participating employer and a good faith estimate of each employer's percentage of the total contributions during the plan year. Contributions include both the employer and the participant contributions. "Open MEPs", however, must file a Form 5500 and audit for <u>each</u> participating employer.

Participating Employers Treated Separately for Other Purposes

Coverage, Nondiscrimination and Top-Heavy Testing

The coverage and nondiscrimination tests are performed by each participating employer as if that employer maintained a separate plan.[6] In addition, each participating employer is treated as having a separate plan for purposes of top-heavy testing.[7] Only related employers are treated as a single-employer for coverage, nondiscrimination and top-heavy testing purposes.

Funding and Deductions

If the multiple employer plan is a pension plan, the minimum funding requirements under IRC §§412 and 430 are determined as if each participating employer maintained a separate plan.[8] An exception applies for plans established before January 1, 1989, under which funding may be determined as if the employers are a single-employer.[9] Similarly, the deduction limits are applied as if each participating employer maintains a separate plan, subject to an exception that permits single-employer treatment for certain plans established before January 1, 1989.[10]

Why Unrelated Employers Participate in a Multiple Employer Plan

An employer may participate in a multiple employer plan because there is a business relationship or some common ownership among the participating employers, even though employers do not satisfy any of the related employer definitions. Economy of scale is also a consideration as

[5] Treas. Reg. §1.415(a)-1(e).
[6] Treas. Reg. §1.413(c)-2(a)(3).
[7] Treas. Reg. §1.416-1, G-2.
[8] IRC §413(c)(4)(A).
[9] IRC §413(c)(4)(B).
[10] IRC §413(c)(6).

participating employers share the expense of maintaining a MEP as well as the potential to mitigate risk of liability.

Common Industry, Business Field

The employers who adopt a multiple employer plan may be in the same industry and have employees that shift employment from one participating employer to another. For administrative convenience, the employers may prefer contributing into a single plan in which all of their employees participate. Doing so provides employees with uninterrupted career-long retirement benefits, which may aid participating employers in employee recruitment efforts.

Leasing Organizations

As noted in the introduction section, a **leasing organization** is a company that employs individuals and then leases the services provided by these individuals to various other companies (known as **recipient organizations** or **recipients**).

A multiple employer plan might be maintained jointly by a leasing organization and the recipient organizations who are clients of the leasing organization, so that contributions or benefits can be better coordinated for coverage and nondiscrimination testing purposes. Leased employees and leasing organizations are discussed later in this chapter.

A professional employer organization (PEO) may be in a purported leasing organization role, but may need to adopt a multiple employer plan approach to avoid an exclusive benefit rule violation if the PEO turns out not to be the common law employer of the employees.[11] By having both the PEO and the recipient organization adopt the plan, the plan can appropriately cover the employees regardless of which entity is the common law employer.

Coordinating Separate Plans as Alternative

As an alternative to the multiple employer plan approach, employers may wish to include coordinating provisions in their separate plans. For example, each employer's plan might credit service for vesting purposes with other employers that otherwise would have been part of the multiple employer plan. A similar approach could be taken for eligibility and benefit accrual purposes. In addition, the plans could arrange for a transfer of benefits from one plan to another when the employee is transferred between employers.

MULTIEMPLOYER PLANS

A **multiemployer plan** is one that is maintained pursuant to one or more collective bargaining agreements to which more than one employer is required to contribute.[12] The IRS has released examination guidelines for multiemployer plans.[13] Section 302(c)(5) of the Taft-Hartley Act requires a multiemployer plan to have a joint board of trustees, comprised of union representatives and employer representatives. These plans will always be individually designed because the pre-approved plan procedures do not accommodate multiemployer plans.

[11] Rev. Proc. 2002-21 and Rev. Proc. 2003-86.
[12] ERISA §3(37) and IRC §414(f).
[13] Announcement 96-25.

Participating Employers Treated as Single-Employer for Certain Purposes

IRC §413(b) allows the participating employers in a multiemployer plan to be treated as a single-employer for certain purposes, even though these employers are not related under any of the related employer definitions under IRC §§414(b), (c), (m) or (o).

Eligibility and Coverage Requirements

Participation under IRC §410 shall be applied as if all employees of each of the employers who are parties to the collective-bargaining agreements and who are subject to the same allocation formula under the plan act as if they were a single-employer. Thus, the plan must apply the minimum age and service requirements under IRC §410(a) and the minimum coverage requirements under §410(b) as if all participating employers constitute a single-employer. Therefore, service with all of the participating employers is counted in determining an employee's eligibility to participate in the plan.

A plan that covers only union employees is deemed to satisfy the coverage rules of IRC §410(b). Special rules apply, however, when the multiemployer plan also covers nonunion employees. The portion of the plan covering nonunion employees is disaggregated from the portion covering union employees, and the portion covering the nonunion employees must be tested for coverage.[14] If an individual is a union employee for part of the year, he or she may be treated as a union employee for coverage purposes if certain conditions apply.[15]

Nondiscrimination

Nondiscrimination testing under IRC §401(a)(4) shall be applied as if all participants who are subject to the same allocation formula and who are employed by employers who are parties to the collective bargaining agreement were employed by a single-employer.

A plan that covers only union employees is deemed to satisfy the nondiscrimination rules of IRC §401(a)(4). Special rules apply, however, when the multiemployer plan also covers nonunion employees. The portion of the plan covering nonunion employees is disaggregated from the portion covering union employees, and the portion covering the non-union employees must be tested for nondiscrimination.[16]

Exclusive Benefit Rule

For purposes of IRC §401(a), in determining whether the plan of an employer is for the exclusive benefit of his employees and their beneficiaries, all plan participants shall be considered to be employees.

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[14] Treas. Reg. §1.410(b)-7(c)(4)(ii)(B).
[15] Treas. Reg. §1.410(b)-6(d)(2)(ii)(A).
[16] Treas. Reg. §1.401(a)-1(c)(5).

Vesting

IRC §411 (except rules for termination or partial termination or discontinuance of contributions under IRC §411(d) (3)) shall be applied as if all employers who have been parties to the collective–bargaining agreements constituted a single-employer, except that the application of any break in service rules shall be made under regulations prescribed by the Secretary of Labor.[17] Thus all hours which an employee worked for each employer in a collective-bargaining agreement would be aggregated in computing the employee's hours of service under the plan.

Funding and Deductions

For pension plans, the minimum funding standard provided by IRC §412 shall be determined as if all participants in the plan were employed by a single-employer. Similarly, the deduction limits are applied as if all participants in the plan were employed by a single-employer.

IRC §415 Limits

For purposes of applying the IRC §415 limits to participant's accounts, compensation and contributions from all of the employers participating in the plan must be taken into account. For example, in a multiemployer plan that is a defined contribution plan, compensation from all of the participating employers is aggregated to determine the participant's IRC §415(c) limit. Then, the annual additions in the plan, with respect to all of the participating employers, are aggregated to determine if that limit is exceeded.[18]

Form 5500 Filing

Only one Form 5500 is filed for a multiemployer plan each year, regardless of the number of contributing employers.

Rules Not Applicable to Multiemployer Plans – Top Heavy Rules

A collectively-bargained plan that includes a key employee of an employer must be included in the required aggregation group.[19] If no key employee is covered by the union plan, the plan is not part of the required aggregation group, but may be permissively aggregated with plans in the required aggregation group.

If a union employee is covered by a top-heavy plan, the minimum benefit requirements under IRC §416(b) do not have to be applied to such employee.[20]

Elements of a Multiemployer Plan

ERISA §3(37) defines a multiemployer plan as a plan:

- To which more than one employer is required to contribute;

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[17] IRC §413(c)(3). DOL Regulation 29 CFR 2530.201(f) and (g).
[18] Treas. Reg. §1.415(a)-1(e).
[19] Treas. Reg. §1.416-1, T-3.
[20] Treas. Reg. §1.416-1, T-3.

- Which is maintained pursuant to one or more collective bargaining agreements; and
- Which satisfies other requirements prescribed by the Department of Labor (DOL).

DOL Reg. §2510.3-37(c) provides that the plan must be established for a substantial business purpose. The following four factors are considered in determining whether there is a substantial business purpose:

A. The extent to which the plan is maintained by a substantial number of unaffiliated contributing employers and covers a substantial portion of the trade, craft or industry in terms of employees or geographic area;
B. The extent to which the plan provides benefits more closely related to years of service within the trade, craft or industry rather than with an employer;
C. The extent to which collective bargaining takes place with respect to other matters; and
D. The extent to which the administrative burden and expense of providing benefits through single-employer plans would be greater than through the multiemployer plan.

The IRS Audit Guidelines for Multiemployer Plans describes, in Part 4, Chapter 72, Section 14.1.5, industries that typically adopt multiemployer plans as follows:

High Worker Mobility or Seasonal Employment

Multiemployer plans are concentrated in industries with high worker mobility or seasonal employment such as construction industry, or where the companies may be too small to justify single-employer plans. Some plans cover only a particular trade or craft, such as electrical workers, while other plans are industry-wide.

Manufacturing Industries

Multiemployer plans are common in manufacturing industries such as food, textiles, the garment industry, printing and publishing, leather products, lumber and wood products, furniture and fixtures, and metal-working.

Nonmanufacturing Industries

Nonmanufacturing industries also have multiemployer plans such as mining, construction, transportation, wholesale and retail trades, services, entertainment and communications.

1.04: Leased Employees and Leasing Organizations

A leased employee is not a common law employee of the recipient organization for which he or she is actually providing services, but is treated under Internal Revenue Code (IRC) §414(n)(1) as an employee of the recipient for qualified plan purposes.[21]

[21] Notice 84-11, 1984-2 C.B. 469.

DEFINITION OF LEASED EMPLOYEES

For an individual to be treated as a **leased employee** under IRC §414(n), the following conditions must be met:

- The leasing organization, not the recipient, must be the common law employer of the individual;
- Services must be provided by the individual under an agreement between the leasing organization and the recipient;
- The individual must be providing services to the recipient on a substantially full-time basis for at least one year; and
- The recipient must have primary direction or control over the individual's services.

Leased Employee Must be Common Law Employee of Leasing Organization

A threshold requirement for treating an individual as a leased employee under IRC §414(n) is that the individual must be the common law employee of the leasing organization.[22] For example, in *Burrey v. Pacific Gas and Electric Co. (PG&E)*,[23] employees were transferred from their current employer (PG&E) to an employment agency, Stafco Personnel Management, Inc. After the employees were transferred, PG&E treated them as leased employees. Because the PG&E retirement plan excluded leased employees, the plaintiffs were excluded from participation. The court ruled that, before it could determine whether the plaintiffs were excludable as leased employees, it first had to determine that they were actually the common law employees of the leasing organization. A similar issue arose in *Vizcaino v. Microsoft Corp*.[24]

As a note of caution, if the leased employees constitute all or substantially all of the recipient's workforce, there also may be an issue as to whether some or all of the leased employees are actually the common law employees of the recipient. If a recipient is concerned that the purported leased employees are actually the recipient's common law employees, or if the recipient is being told that the individuals who provided services to the recipient are neither the recipient's common law employees nor the recipient's leased employees, it would be in the recipient's best interest to obtain appropriate counsel regarding the status of these individuals. If the purported leasing organization is not actually the common law employer, a plan maintained by that organization for the benefit of the recipient's employees is not a qualified plan, and, unless corrective steps are taken in accordance with Revenue Procedure (Rev. Proc.) 2002-21, the tax-deferred status of those benefits is in jeopardy.

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[22] Notice 84-11, Q&A-1, Rev. Proc. 2002-21, §3.04, *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992) (common law definition of employee applies to entitlement to receive benefits under a plan) and *Professional and Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225 (1987), aff'd, 862 F.2d 751 (9th Cir. 1988) (exclusive benefit rule violation if plan not sponsored by common law employer of participants).
[23] 159 F.3d 388 (9th Cir. 1998).

[24] 22 EBC 1777 (W.D. Wash. July 15, 1998).

As will be discussed later in this chapter, there are times when the leasing organization may cover the leased employees in its own plan. The leased employee must be the common law employee of the leasing organization, and not of the recipient employer, in order to be treated as an employee of the leasing organization for plan purposes.[25] If the leasing organization is not really the common law employer of the leased employee, but merely the payroll agent of the recipient, the leased employees should not be covered in a plan maintained solely by the leasing organization. The leasing organization would be violating the exclusive benefit rule under IRC §401(a)(2) if it covered such individuals in its plan, because a qualified plan may cover only the employees or former employees of the employer that maintains the plan.

Services Provided Pursuant to an Agreement

The services must be performed under an agreement between the recipient and a leasing organization.[26] The agreement can be written or informal, where the leasing organization provides the services of the individual to the recipient, usually for a fee.[27] The ability of this arrangement to be informal means that anytime an individual who is the common law employee of one organization provides services to another organization, one must at least question whether there is a leasing situation.

Substantially Full-Time for at Least One Year

The individual's services must be performed for at least one year on a substantially full-time basis.[28] Substantially full-time service means 1,500 hours in a 12-month period (or 75 percent of the customary hours in that job position, if less than 1,500 hours).[29]

If a leased employee previously worked as a common law employee for the recipient, that service is taken into account to determine if this one-year substantially full-time service rule is satisfied.[30] The one-year substantially full-time service rule need only be satisfied once for an individual to be considered a leased employee in all future plan years.

EXAMPLE 1-1. Common Law Employee Becomes a Leased Employee. Employee M worked as a full-time employee for Corporation X for the last two years. Employee M's employment with Corporation X is now being terminated, and is being immediately hired by Leasing Company. Leasing Company has a contract to provide employee services to Corporation X, and leases Employee M to Corporation X. Employee M already satisfies the substantially full-time service requirement as of the start date as a leased employee, because the prior service as a common law employee of Corporation X is counted.

[25] Notice 84-11, Q&A-1 and Rev. Proc. 2002-21, §3.04.
[26] IRC §414(n)(2)(A).
[27] Notice 84-11, Q-6.
[28] IRC §414(n)(2)(B).
[29] Notice 84-11, Q-7.
[30] Notice 84-11, Q-8.

Primary Direction or Control by the Recipient

The recipient employer must have primary direction or control over the services rendered by the individual.[31] Who has primary direction or control is based on the facts and circumstances of a given situation. Relevant factors include:

- When, where and how the individual is to perform services;
- Whether the services must be performed by a particular person;
- Whether the individual is subject to supervision by the recipient employer; and
- Whether services must be performed in the order or sequence set by the recipient employer.

It is not relevant whether the recipient employer has the right to hire or fire the individual or whether the individual works for others. In fact, if the recipient has the right to hire or fire, it will likely raise an issue as to whether the leased employee is really the common law employee of the recipient, rather than a common law employee of the leasing organization.

The Conference Report to the Small Business Job Protection Act (SBJPA), (under which IRC §414(n) was enacted) notes that secretaries, receptionists, word processing and similar office personnel and nurses in a doctor's office typically satisfy the Recipient organization. On the other hand, professionals who regularly make use of their own judgment and discretion on matters of importance in the performance of their services and are guided by professional, legal or industry standards generally do not satisfy this test.

TREATMENT OF LEASED EMPLOYEE AS AN EMPLOYEE OF THE RECIPIENT FOR CERTAIN QUALIFICATION RULES

Once an individual satisfies the leased employee definition, he or she is treated as an employee of the recipient as of the close of the one-year qualifying period described above. Once the one-year period has been satisfied, all service during the period the individual is a leased employee is credited for eligibility and vesting purposes, including service earned during the one-year qualifying period.[32] As discussed earlier, if the leased employee was formerly an employee of the recipient (i.e., the recipient had been the employer of the individual but then the individual's employment was transferred to the leasing organization and leased back to the recipient), services performed as the recipient's common law employee are also counted for plan purposes.

Effect on Plan Qualification Requirements

A leased employee is treated as an employee for purposes of applying the nondiscrimination tests under IRC §§401(a) (4), 401(k) and 401(m), eligibility rules under IRC §410(a), vesting rules under IRC §411, coverage tests under IRC

§410(b), compensation dollar limit under IRC §401(a)(17), IRC §415 limitations and top-heavy rules under IRC §416.[33] Although IRC §414(n)(3) does not specifically list the highly

[31] IRC §414(n)(2)(C).
[32] IRC §414(n)(4)(B).
[33] IRC §414(n)(3).

compensated employee (HCE) definition under IRC §414(q), leased employees are treated as employees for purposes of making the HCE determination. The HCE determination is a term incorporated by reference into the coverage and nondiscrimination testing rules of IRC §§401(a)(4), 401(k), 401(m) and 410(b), which are referenced in IRC §414(n)(3).

IRC §414(n) does not cross-reference IRC §409(l). Therefore, the Internal Revenue Service (IRS) apparently is of the view that leased employees may not participate in an employee stock ownership plan (ESOP) maintained by the recipient organization (or a member of its controlled group).[34]

Contributions and Benefits Under Leasing Organization's Plan Treated as Provided by Recipient

To determine whether the above listed qualification requirements are satisfied, allocations of contributions to a defined contribution plan, or benefits provided under a defined benefit plan maintained by the leasing organization, are treated as provided by the recipient if attributable to services performed for the recipient.[35]

EXAMPLE 1-2. Benefits Earned in Plan of Leasing Organization Considered by Recipient. LO, a leasing organization, has a profit-sharing plan that provides a contribution equal to 3% of a leased employee’s compensation for the plan year. J is a leased employee with LO, and J’s services for that year are performed solely for Corporation X. When Corporation X determines whether its qualified plan satisfies these qualification requirements, the 3% contribution provided under LO’s plan is treated as if it were provided by Corporation X. If a leased employee provides services to two or more recipients (who are not related employers), then each recipient takes into account only the contributions or benefits attributable to the services performed for that recipient.

Exclusive Benefit Rule Not Violated by Recipient that Covers Leased Employees in its Plan

Although IRC §414(n)(3) does not reference the exclusive benefit rule under IRC §401(a)(2), the IRS refers to this section in Notice 84-11, Q&A-2. Thus, a recipient’s inclusion of leased employees in its qualified plan will not violate the exclusive benefit rule, even though a qualified plan is supposed to be for the benefit of the recipient’s employees and the leased employees are actually employees of the leasing organization.

Deductibility of Contributions Made by Recipient on Behalf of Leased Employees

Although IRC §414(n)(3) does not discuss the deduction limits under IRC §404, Notice 84-11, Q&A-2, also adds a reference to that section. Thus, a contribution made by the recipient to its own

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[34] Q&A-26 of the American Bar Association’s Q&A session with the IRS on May 7, 2004, which is available at the ABA Web site.

[35] IRC §414(n)(1)(B).

plan for the benefit of the leased employees is deductible under IRC §404, assuming the deduction limits are not exceeded. Note that this deduction rule applies only for contributions actually made to a plan by the recipient. The recipient will not take deductions under IRC §404 with respect to contributions made by the leasing organization in relation to work performed by the employee for the recipient, because those contributions are made by the leasing organization. The leasing organization will claim those qualified plan deductions, as the common law employer of the leased employees and the sponsor of the plan to which it is contributing.

Additional Implications of Contributions Made on Behalf of Leased Employees

The recipient indirectly bears the economic consequences of contributions made to a plan by a leasing organization because such payments will be factored into the fees paid by the recipient to the leasing organization for the services of the leased employees. Thus, defined contribution plan allocations or defined benefit plan accruals funded with the contributions made by the leasing organization should be taken into account by the recipient to determine if the qualification requirements listed in IRC §414(n)(3) have been satisfied. However, the leasing organization's plan does not always cover the leased employees. If it does, the contributions or benefits provided in that plan may not be sufficient to enable the recipient to satisfy the coverage and nondiscrimination tests with respect to its own plan. In this latter scenario, the recipient needs to be able to make and deduct, under IRC §404, any additional contributions to its own plan(s) for the benefit of the leased employees so that its plan can pass the coverage and nondiscrimination testing.

Recipient Employer Does Not Maintain a Plan

Suppose the recipient does not maintain a qualified plan at all. Instead, the leased employees are covered only by a plan maintained by the leasing organization. The qualification requirements described in IRC §414(n)(3) still apply to the recipient, because IRC §414(n)(1)(B) says that contributions or benefits shall be treated as provided by the recipient. Thus:

- If any of the leased employees covered by the leasing organization's plan are HCEs with respect to the recipient, the appropriate coverage and nondiscrimination tests must be performed at the recipient level;
- If any of the leased employees covered by the leasing organization's plan are key employees with respect to the recipient, top-heavy testing has to be performed at the recipient level; and
- The recipient must keep records to determine the service earned by the leased employees with the recipient so that, in the event the recipient later establishes a qualified plan that covers any of the leased employees (or leased employees who later become common law employees of the recipient), appropriate service credits are given to such employees.

Safe Harbor Plan Exception

A recipient may avoid treating the leased employees as its own employees for plan purposes, if the leasing organization sponsors a **safe harbor plan** and the recipient meets certain requirements. When leased employees are disregarded because of the safe harbor plan exception, the recipient does not treat such individuals as its employees for purposes of complying with the qualification requirements and would not cover (nor have any authority to cover) such employees in a plan maintained by the recipient.

Definition of Safe Harbor Plan

A safe harbor plan must meet the following requirements:

- Be a money purchase pension plan;
- Provide each participant with a nonintegrated contribution rate of at least 10 percent of IRC §415 compensation;[36]
- Provide for 100 percent immediate vesting; and
- Allow immediate participation (no age or service requirement).[37]

The safe harbor plan requirements do not apply to employees who perform substantially all of their services for the leasing organization, or employees who receive less than $1,000 in compensation each year from the leasing organization in each of the current and preceding three plan years.[38]

Workforce Must Not be More than 20 Percent Nonhighly Compensated Leased Employees

The safe harbor plan exception does not apply if more than 20 percent of the recipient's nonhighly compensated workforce consists of leased employees.[39] To the extent that employers were motivated to use employee leasing as a means of excluding the employees from their own retirement plans, this limitation has made that practice ineffective. As a result, employers who still lease employees do so for some other reason, and either exclude the leased employees permissibly from their plans under the coverage rules, or simply cover the leased employees in their plans.

EXAMPLE 1-3. Safe Harbor Exception Applies. Corporation X has 150 employees, of whom 10 are HCEs. It also receives services on a continuous basis from 20 leased employees provided through an unrelated Corporation, L. Corporation L maintains a money purchase pension plan for the benefit of its employees (including the leased employees that perform services for Corporation X). The money purchase pension plan satisfies the above definition of a safe harbor plan. Because the leased employees represent 20.0% or less of Corporation X's nonhighly compensated workforce (i.e., 20 of 160 NHCEs is 12.5%), the leased employees are not treated as Corporation X's employees for qualified plan purposes. Corporation X disregards the leased employees in determining whether its own plan satisfies the coverage requirements under IRC §410(b). Corporation X also does not have to compare the benefits it provides under its plan with those provided by Corporation L to the leased employees under the safe harbor plan, for

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[36] IRC §414(n)(5)(C)(iii).
[37] IRC §414(n)(5)(B).
[38] IRC §414(n)(5)(B)(iii).
[39] IRC §414(n)(5)(A).

purposes of determining whether Corporation X's plan satisfies the coverage and nondiscrimination testing requirements.

EXAMPLE 1-4. Safe Harbor Exception Does Not Apply. Suppose in the prior example that Corporation X has only 40 employees, 10 of whom are HCEs. Now the 20 leased employees represent 40% of Corporation X's nonhighly compensated workforce (i.e., 20 of 50 total NHCEs). In this case, because leased employees account for at least 20% of the NHCE workforce, the leased employees must be treated as Corporation X's employees for qualified plan purposes, even though they are covered under a money purchase pension plan that satisfies the safe harbor plan definition.

Corporation X, however, may take into account the 10% contribution the leased employees receive under Corporation L's money purchase pension plan in determining whether Corporation X's plan satisfies the nondiscrimination and coverage requirements. For example, suppose the Corporation X plan is a profit-sharing plan that would otherwise provide an 18% contribution for a particular plan year. The leased employees would have to receive only an 8% contribution, because Corporation X is treated as providing the other 10% under the money purchase pension plan maintained by Corporation L. This assumes that the leased employees perform all their services for Corporation X so that Corporation X may take credit for the entire contribution made to Corporation L's money purchase pension plan on behalf of the leased employees.

Participation by Leased Employees in 401(k) Plans

Presumably, a leased employee may participate in a 401(k) plan maintained by the recipient employer, even though the leased employee does not receive any direct compensation from the recipient from which the recipient could withhold elective contributions (pre-tax elective contributions, catch-up contributions and designated Roth Contributions). The IRS has not issued any guidance on leased employees participating in a recipient's 401(k) plan. In the absence of formal guidance, any reasonable approach should be acceptable.

Because of the lack of IRS guidance, covering leased employees under a 401(k) plan has been handled in many different and creative ways. Some leasing organizations will set up 401(k) plans in which the leased employees participate. In such cases, the recipient employer may establish a separate 401(k) plan for its common law employees and take credit for the pre-tax elective contributions and designated Roth contributions made by the leased employees into the leasing organization's 401(k) plan when applying coverage and nondiscrimination testing to the recipient's separate 401(k) plan. In other words, the recipient aggregates its 401(k) plan with the portion of the 401(k) plan maintained by the leasing organization that covers the leased employees provided to that recipient for purposes of the recipient's ADP and ACP testing under IRC §§401(k) and 401(m).

Some leasing organizations allow each recipient to negotiate a different rate of match that is to be provided to the recipient's leased employees who are covered under the leasing organization's plan. The recipient's plan then provides a mirror match for the recipient's common law employees. In some situations, the leasing organization's 401(k) plan provides only for elective contributions, and each recipient funds the related matching contribution for its leased employees under its separate plan. In other words, only the common law employees of the recipient make elective contributions under the recipient's 401(k) plan, but both common law employees and leased employees receive matching contributions under the recipient's 401(k) plan. The matching contributions allocated to leased employees are determined on the basis of the elective contributions the leased employees make to the leasing organization's 401(k) plan. If this structure is used, it is important that the recipient plan be drafted to relate the leased employees' matching contributions to the elective contributions made to the other plan.

Multiple Employer Plan Approach

In some situations, recipient employers have become participating employers in the leasing organization's plan, creating a multiple employer plan in which the leasing organization and its clients (i.e., the recipients) participate in a single plan for administrative convenience. The design of these multiple employer plans can vary. Sometimes, the leasing organization co-sponsors a separate plan with each recipient that is a client of the leasing organization. Other times, a single multiple employer plan is established in which the leasing organization and all recipients that are clients of the leasing organization participate. At the end of this chapter there is a chart comparing the treatment of a single-employer plan to a multiple employer plan.

A word of caution: 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.[40]

Employee Who Becomes a Leased Employee

In some cases, an employee of the recipient will later become a leased employee of the same recipient. This usually arises when an employer contracts with a leasing organization to assume employer responsibilities over the employer's current workforce (or a portion of that workforce) and the leasing organization then leases back those employees to the employer. When this occurs, there is no interruption of the leased employees' treatment as employees for the qualified plan requirements, because their prior service as common law employees must be counted by the recipient.[41]

[40] Rev. Proc. 2002-21, I.R.B. 2002-18.
[41] Notice 84-11, Q&A-8.

Right to Continued Participation in the Plan

If the individual was covered by the recipient's plan when he or she was a common law employee of the recipient, will the individual continue to participate in the plan after becoming a leased employee with respect to the recipient? That depends. If the plan excludes leased employees as a classification, then the individual's participation in the plan will be discontinued. Of course, the recipient's plan would have to be able to satisfy the coverage requirements under IRC §410(b) without covering the leased employees (although contributions or benefits provided by the leasing organization, if any, may be taken into account to satisfy the coverage requirements). If the plan does not exclude leased employees, then the individual's participation in the plan will continue uninterrupted.

EXAMPLE 1-5. Employee Becomes Leased Employee. J is an employee of Corporation X and is an eligible participant in the X profit-sharing plan. The plan year ends December 31. Effective June 1, J's employment is transferred to Leasing Company, which leases J to Corporation X. The Corporation X plan excludes leased employees. J's right to participate in the plan is discontinued as of June 1. If the plan is a 401(k) plan, J may not defer to Corporation X's plan any compensation paid to J as a leased employee of Corporation X because leased employees are excluded from the Corporation X plan.

Allocations for Year of Discontinuance Will Depend on Terms of Plan

Whether an individual, who was a participant in the recipient's plan and terminated during the plan year to become a leased employee, will receive an allocation of contributions will depend on the terms of the plan.

Some defined contribution plans require employment on the last day of the plan year as a condition to sharing in the allocation of contributions. An individual is still treated as employed on the last day of the plan year, even though he or she is a leased employee as of such date.

If the plan is top-heavy, and the leased employee is not a key employee with respect to the recipient, the top-heavy minimum for the plan year in which he or she becomes a leased employee must be based on the entire year's compensation.[42]

Vesting Service Continues to be Credited

When an employee of the recipient becomes a leased employee, the change in status will not affect his or her right to increase vesting in the recipient's plan. The service performed for the recipient as a leased employee will count for vesting purposes in the recipient's plan, as well as any plan sponsored by the leasing organization.

Application of IRC §415 Limits

IRC §414(n)(3) requires a recipient to treat the leased employee as an employee for IRC §415 purposes. If the leased employee participates in both the recipient's defined contribution plan and

[42] Treas. Reg. §1.416-1, M-7.

the leasing organization's defined contribution plan in the same limitation year, contributions and forfeiture allocations to both plans must be aggregated to determine if the recipient's plan violated the IRC §415 limits.

No Severance from Employment

When a common law employee becomes a leased employee, there is no severance from employment.[43] This means the individual is not eligible for a distribution from the recipient's plan due to a termination of employment.

Leased Employee Who Becomes a Common Law Employee of the Recipient

We discussed above the consequences of a common law employee becoming a leased employee. What if the opposite situation occurs, where a leased employee is later hired by the recipient as a common law employee? In that case, the recipient will treat the new employee like any other employee for all purposes under the qualified plan rules, not just those listed in IRC §414(n)(3). Also, the employee's service as a leased employee is counted by the recipient for eligibility and vesting purposes.[44] If the individual did not meet the requirements to be considered a leased employee, then service with the leasing organization will not be counted towards the recipient's plan, unless the plan provisions specifically allow such credit.

Participation in the Plan

How the change to common law employee status affects plan participation depends on how the recipient's plan deals with leased employees for eligibility purposes. If leased employees are excluded by classification, then the individual's hiring as a common law employee will be treated like any other change in employment classification. If the classification as a leased employee was the only reason why the individual was not eligible, and the individual has satisfied all other eligibility requirements, the individual will become a participant immediately upon his or her being hired as a common law employee. If the employee still must satisfy other eligibility conditions (e.g., the employee did not satisfy the year of service requirement as a leased employee), then those conditions would have to be satisfied before the common law employee becomes a participant. If the plan does not exclude leased employees by classification, the employee's participation in the plan would continue uninterrupted after he or she becomes a common law employee of the recipient, assuming the employee had met the plan's eligibility conditions while a leased employee.

EXAMPLE 1-6. Leased Employee Later Hired as Common Law Employee. X commences services with Corporation W on April 1 as a leased employee. X performs services on a substantially full-time basis so that, if X performed such

[43] This conclusion is based on the principles set forth in GCM 39824, which the IRS appears to be applying, as evidenced in Notice 2002-4. The Treasury also reaches this conclusion, that a change of status from common law employee to leased employee is not a severance from employment, in the preamble to the final 401(k) regulations issued on December 29, 2004. See 69 F.R. 78148 (middle column).
[44] Notice 84-11, Q&A-8.

services for a 12-month period, X would be treated as a leased employee under IRC §414(n). On September 1, Corporation W hires X as a common law employee, and X is terminated as an employee of the leasing organization. Corporation W's plan requires one year of service for eligibility purposes. X's employment commencement date for eligibility service purposes is April 1, not September 1. Thus, if X completes at least 1,000 hours of service during the 12-month period measured from April 1 to the following March 31 (including hours credited for the five months as a leased employee), X would have credit for a year of service for eligibility purposes under Corporation W's plan as of such date.

Vesting Service

To determine vesting rights under the recipient's plan, the common law employee's prior service as a leased employee would be taken into account, regardless of whether the employee was allowed to participate in the plan while performing services as a leased employee.

Application of IRC §415 Limits

As discussed above in relation to common law employees who become leased employees, an individual's annual additions in both the recipient's defined contribution plan and the leasing organization's defined contribution plan in the same limitation year are aggregated, to determine if the recipient's plan violates the IRC §415 limits. Therefore, if a leased employee becomes a common law employee in the middle of a plan year, the recipient plan must take into account the annual additions credited in the leasing organization's plan for the part of the limitation year during which he or she was a leased employee to determine if the annual additions credited in the recipient's plan while he or she is a common law employee exceed the IRC §415 limit. On the other hand, the contributions and forfeiture allocations to the leased employee's account in the recipient plan do not count as annual additions for purposes of determining whether the leasing organization plan meets the §415 limitations.

Severance from Employment

Similar to the earlier discussion about when common law employees become leased employees, there is also no severance from employment from the leasing organization when a leased employee becomes a common law employee for the recipient. However, this rule probably applies only with respect to contributions or benefits accrued under a plan maintained by the recipient for the services performed as a leased employee. The leasing organization's plan should be able to treat the individual as having severed from employment, and allow for a distribution from that plan. This would be consistent with IRC §414(n)'s focus on the recipient with respect to the application of the qualified plan rules.

NO COMMON OWNERSHIP BETWEEN RECIPIENT AND LEASING ORGANIZATION REQUIRED

There does not have to be any common ownership between the leasing organization and the recipient for the leased employees to be treated as employees of the recipient for qualification purposes. In fact, if there is common ownership, it should first be determined whether the leasing organization and the recipient are part of an affiliated service group or a controlled group of businesses. If there is such a relationship, then the employees of both companies are treated as employed by a single-employer for qualified plan purposes and the leased employee designation is not important. If there is no such relationship, then only the leased employees who perform services for the recipient are treated as employees of the recipient. The other employees of the leasing organization would not be treated as the recipient's employees for qualified plan purposes.

If You're Curious …

IRS Determination

In our discussion of leased employees, we have made several references to the common law employer/employee relationship, and the fact that the leasing organization must be the common law employer of the leased employee, or IRC §414(n) is not applicable and the purported leased employee is simply the employee of the recipient. In the past the IRS did entertain a request to make an employer/ employee relationship determination as part of an application for a determination letter on a qualified plan. Effective in 2015, Rev. Proc. 2015-6, Section 6.12 of the IRS' general determination letter procedure states:

Employee Plans of the Tax Exempt and Government Entities Division of the Service does not make determinations regarding the existence of an employer-employee relationship as part of its determination on the qualification of a plan, but relies on the applicant's representations or assumptions, stated or implicit, regarding the existence of such a relationship. Taxpayers are reminded, however, that they may file Form SS–8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the Service to determine the employment status of the individuals involved prior to filing an application for a determination letter on the qualified status of the plan[45]

However, Rev. Proc. 2015-6, Section 5.08 goes on to state:

Applicants may elect that the letter include a determination as to whether: (1) the employer is a member of an affiliated service group within the meaning of §414(m), (2) leased employees are deemed employees of the employer under the meaning of §414(n), and/or (3) a partial termination has occurred with respect to the plan, and if so, its impact on plan qualification.

Thus, if an employer is not sure whether certain individuals should be treated as leased employees under IRC §414(n), it may, if eligible, be able to apply to the IRS for a determination on this issue. Application is made on IRS Form 5300. See the IRS' general determination letter procedure for more details on the application process. Starting in 2017, a request for a determination letter on leased employee status under an individually-designed plan is permitted only if the plan is otherwise eligible to file for a determination letter. Pursuant to Rev. Proc. 2016-37, individually-designed plans are generally permitted to file for a determination letter only for initial qualification (i.e. the plan has never obtained a determination letter before) and upon plan termination.

[45] Rev. Proc. 2015-6, IRB 2015-1, §6.12.

LEASED EMPLOYEES TREATED AS EMPLOYEES OF THE LEASING ORGANIZATION

Although an employee of the leasing organization is treated as a leased employee with respect to a recipient, and taken into account in applying various qualification requirements to the recipient's plan, the individual is still the common law employee of the leasing organization. Thus, the leased employee is also treated as an employee for purposes of applying the qualification requirements to a plan maintained by that leasing organization. Furthermore, any contributions or benefits provided to the leased employee in a plan maintained by the recipient are not treated as provided by the leasing organization for purposes of applying the qualification requirements to the leasing organization's plan. In other words, the crediting rule described in IRC §414(n)(1)(B) that allows the recipient to consider contributions and benefits provided by the leasing organization as if they were provided in the recipient plan does not work in reverse! Also, service with the recipient that was performed before the leasing organization hired the leased employee is not required to be credited by the leasing organization's plan.

EXAMPLE 1-7. Plan Sponsored by Leasing Organization. Corporation L is a leasing organization. Corporation L employs 800 employees. Of these employees, 735 work exclusively for several recipient employers and 65 work exclusively in Corporation L's corporate offices. The 735 employees who work for recipients are treated as leased employees under IRC §414(n) with respect to those recipients. The recipients are not related to Corporation L under the affiliated service group or controlled group definitions. Corporation L establishes a qualified plan that covers only the 65 employees in the corporate offices. To determine whether the Corporation L plan satisfies the coverage requirements under IRC §410(b), Corporation L must take into account all of its employees who are not excludable employees for coverage testing purposes, including those who are treated as leased employees of the recipients. If the 65 employees benefiting from Corporation L's plan cannot satisfy the coverage requirements, the plan is not qualified.

Even though one or more recipients may need to apply certain qualification requirements as if the leased employees were their employees, the leasing organization, as the common law employer of these individuals must also perform the appropriate compliance testing for its plan as a whole. The compliance tests for this purpose include coverage tests under IRC §410(b), nondiscrimination tests under IRC §§401(a)(4), 401(k) and 401(m) and top-heavy tests under IRC §416. The leasing organization applies these tests like any other employer, taking into account the employees who perform services for the leasing organization, as well as employees who provide services to recipient employers, regardless of whether such employees are also treated as the leased employees of the recipient and have to be included in the compliance tests performed by the recipient. In other words, to the extent employees of the leasing organization are also leased employees of one or more recipients, such employees are actually counted twice in compliance testing: once at the leasing organization's level, where all employees of the leasing organization are taken into account, and again at the recipient's (i.e., worksite) level, where the leased employees with respect to that recipient, along with the recipient's common law employees, are taken into account.

EXAMPLE 1-8. Coverage and Nondiscrimination Testing in Leasing Organization Plan and Plans of Recipients. Company L is a leasing organization. Company L is the bona fide common law employer of the individuals who provide services to the recipients, so it is properly treated as a leasing organization under IRC §414(n). Companies X, Y and Z are unrelated organizations that receive services from employees of Company L and are collectively referred to as the recipients. The Company L employees who provide services for the recipients provide their services exclusively for one recipient and satisfy the definition of a leased employee under IRC §414(n). Companies X, Y and Z maintain separate qualified plans that cover their respective common law employees. Company L maintains a qualified plan that covers all of its common law employees, including the leased employees of Companies X, Y and Z. Following are the employee numbers for the organizations.

Organization	Leased Employees	Common Law Employees
L	0	140
X	30	10
Y	65	6
Z	12	2
Total	107	158

The 140 common law employees of Company L, as shown in the table, include the 107 leased employees of Companies X, Y and Z, listed in the middle column, but do not include the 18 common law employees of X, Y and Z that are listed in the third column.

• Compliance tests performed by Company L. When performing compliance testing on its plan, Company L takes into account all of its 140 common law employees (except to the extent they are properly excludable under the applicable compliance testing rules), including the 107 employees leased to Companies X, Y and Z. It does not take into account the 18 common law employees of Companies X, Y or Z, nor any contributions or benefits provided by the plans sponsored by Companies X, Y and Z—even contributions or benefits under those plans that are provided to employees of Company L in their capacity as leased employees of Companies X, Y or Z.

• Compliance tests performed by Company X. When Company X performs these compliance tests, it takes into account the contributions or benefits it provides in its separate plan (including contributions or benefits, if any, it provides to its 30 leased employees), and contributions or benefits provided by Company L's plan for the 30 leased employees of Company X. Note that Company X may or may not provide contributions or benefits in its separate plan for its 30 leased employees. That depends on the level of contributions or benefits these employees received under Company L's plan and whether Company X needs to increase that level to provide the contributions or benefits it wishes to provide to its common law employees and be able to pass the applicable compliance tests.

• Compliance tests performed by Company Y or Company Z. Companies Y and Z apply the compliance tests in the same manner as Company X, except they take into account only their respective leased employees and common law employees, the contributions or benefits provided under their respective separate plans, and the contributions or benefits provided under Company L's plan to their respective leased employees.

This discussion and the above example illustrate why resolving the common law employer issue is so important. If the leasing organization is not actually the common law employer of an individual, but rather the recipient is the individual's common law employer, then such individual should not be treated by the leasing organization as its employee and should be disregarded when the leasing organization performs its compliance tests with respect to plans covering its workforce. It also means that there is an exclusive benefit rule issue that must be resolved if such individuals have been covered by the leasing organization's plan, if the recipient who is the common law employer of that individual is not a participating sponsor of the leasing organization's plan.

In the context of the above example, if Company L is not actually the common law employer of the leased employees, then it should be performing compliance tests only with respect to the 33 employees who are actually its common law employees (i.e., 140 minus the 107 leased employees). In addition, the contributions or benefits provided under Company L's plan for those 107 leased employees violate the exclusive benefit rule, because Companies X, Y and Z are not co-sponsoring that plan as a multiple employer plan arrangement. (See, however, Rev. Proc. 2002-21 for possible relief.)

Participation in Plan by Leased Employee			
	Single-Employer Plan		Multiple Employer Plan (MEP)
Sponsored By	**Recipient (R)**	**Leasing Organization (LO)**	**Both R and LO***
Years of Service for Eligibility and Vesting	All service as a leased employee (LE) counts towards eligibility and vesting in recipient's plan	All service as a common law employee of LO counts toward eligibility and vesting in LO's plan. Service with R as a common law employee of R is disregarded	Years of service with all participating employers are aggregated – special break in service rules apply

Participation in Plan by Leased Employee			
	Single-Employer Plan		Multiple Employer Plan (MEP)
Sponsored By	**Recipient (R)**	**Leasing Organization (LO)**	**Both R and LO***
Nondiscrimination Testing	Benefits/contributions from LO and R plans included	Benefits/contributions from LO plan included, from R plan disregarded	Tested separately for each R vs. LO but LO provided benefits/contributions considered in both R and LO tests
LE Eligible	Yes, included when eligibility and leased employee requirements met – unless plan excludes LE by definition (plan must meet coverage and nondiscrimination testing)	Yes, included when eligibility requirements met	Yes, included when eligibility requirements met
Coverage Testing	LE included	LE included	Tested separately for each R vs. LO but LE considered in both
Compensation Limit	Include only compensation earned by LE with the R	Include compensation earned by LE from all R	Contributions from LO and all Rs, who adopted, are aggregated
451 Limit	Included – aggregate contributions of LO with R for testing	Include only contributions from LO plan not from R plan	Contributions from LO and all Rs, who adopted, are aggregated
Top-heavy Rules	LE included	LE included	Tested separately for each R vs. LO but LE considered in both
HCE Determination	LE included	LE included	LE included
ESOP Participation	Excluded	LE included	LE included
Participation by LE Violates Exclusive Benefit Rule	No	No – provided LE are truly common law employees of LO	No – treated as if LO and R are a single-employer
Deductible	Contribution made by R deductible by R	Contribution made by LO deductible by LO	Deducted separately by each R and LO

Participation in Plan by Leased Employee

	Single-Employer Plan		Multiple Employer Plan (MEP)
Sponsored By	**Recipient (R)**	**Leasing Organization (LO)**	**Both R and LO***
Can Contributions Made by the Other Organization be Considered in Compliance Testing	Yes – contributions of LO can be considered for coverage and nondiscrimination in R's plan	No – contributions of the R are not taken into account for coverage and nondiscrimination in LO's plan	Yes
Safe Harbor Plan Sponsored by LO	LE not treated as employees for R plan if R eligible to use safe harbor exception	LE treated as employee only of LO plan if R eligible to use safe harbor exception	LE treated as employee only of LO plan for compliance testing if R eligible to use safe harbor exception and MEP meets safe harbor requirements
Elective Contributions	Made to LO plan (because compensation paid there), but R takes credit for them for match, coverage and nondiscrimination testing	Made to plan	Made to plan
Matching Contributions	May be made by R based on elective contributions contributed to LO's plan	Coordinated between LO and R	Coordinated between LO and all R
Common Ownership Between Organizations for LO to be Treated as Employee	None needed	None needed	None needed
Form 5500 Filing	Filed separately from LO's plan	Filed separately from R's plan	Only one Form 5500 for the plan regardless of number of participating employers unless it is considered an "open MEP"
* Sometimes one plan with all Rs of LO and sometimes, separate plans for LO and each R.			

1.05: Review of Key Concepts

- What is a multiple employer plan?
- How are multiple employer plans administered as single-employer plans?
- How are multiple employer plans administered as separate plans?
- What is a multiemployer plan?
- How are multiemployer plans administered as single-employer plans?
- What rules are not applicable to multiemployer plans?
- Define leased employee, leasing organization and recipient organization.
- Describe the four requirements that must be met to treat an individual as a leased employee.
- How does a leased employee affect the plan of a recipient organization?
- Compare the treatment of leased employees in a recipient organization's single-employer plan and leasing organization's single-employer plan to that of a multiple employer plan sponsored by the leasing organization with participating recipient organizations.

1.06: For Practice – True or False Questions

1. A multiple employer plan applies coverage testing under IRC §410(b) separately for each unrelated employer.
2. A multiemployer plan is maintained under a collectively bargained agreement between an employee organization and more than one unrelated employer.
3. A multiple employer plan is one adopted by two or more employers where at least two of the participating employers are not members of the same related group.
4. A multiple employer plan, sponsored by the leasing organization, may allow all the leasing organization's recipient organizations to participate.
5. Substantially full-time service means 1,500 hours in a 12-month period (or 75% of the customary hours in that job position, if less).
6. Whether the recipient organization has the right to hire or fire an individual is a relevant factor in the primary direction or control test in determining whether the individual is a leased employee.
7. Benefits, contributions and compensation from all employers participating in a multiple employer plan sponsored by a leasing organization would be aggregated for each participant's account from both the leasing organization and the recipient organization for computing the IRC §415 limit.
8. Years of service with both the leasing organization and the recipient organization are aggregated if they both are participating employers in the same multiple employer plan.
9. The leased employee is included in the recipient and the leasing organization's single-employer plans for HCE determination.
10. A multiple employer plan, sponsored by the leasing organization, must perform coverage testing separately for the leasing organization and the recipient organization.

1.07: Sample Test Questions

1. All of the following are conditions for an individual to be considered a leased employee, EXCEPT:

   A. The recipient and leasing organization must have an agreement covering the services of the individual.

   B. The individual must be providing services on a substantially full-time basis for at least one year.

   C. The recipient must have primary direction or control over the individual's services.

   D. The leasing organization must be the common law employer of the individual.

   E. The individual must be covered by the leasing organization's plan.

2. Which of the following statements regarding the treatment of leased employees in the recipient's plan is/are TRUE?

   I. They are treated as employees for purposes of applying the nondiscrimination tests under IRC §§401(a)(4), 401(k) and 401(m).
   II. They are treated as employees for purposes of determining who are HCEs.
   III. They may not participate in an employee stock ownership plan (ESOP).

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

3. Which of the following statements regarding the leasing organization's multiple employer plan is/are TRUE?

   I. Only one Form 5500 is filed regardless of the number of recipients participating.
   II. Contributions from both the leasing organization and the participating recipients are aggregated to determine the IRC §415 limit.
   III. Contributions made by the leasing organization and the participating recipients are aggregated then prorated, based on the number of leased employees, to the organization for deduction purposes.

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

4. All of the following are relevant factors in determining if the recipient has primary direction or control over services of leased employee, EXCEPT:

   A. Whether services must be performed by a particular person
   B. Whether services must be performed in the order or sequence set by the recipient

C. Whether the individual is subject to supervision by the recipient
D. Whether the recipient has the right to hire or fire the individual
E. When the individual is to perform services

5. All of the following statements regarding multiple employer plans are TRUE, EXCEPT:

   A. The plan must apply the minimum age and service eligibility requirements as if each employer were participating in a single-employer plan.
   B. The plan must consider each unrelated employer separately for purposes of coverage testing under IRC §410(b).
   C. The plan must consider each unrelated employer separately for purposes of ADP testing.
   D. Each employer must recognize service for vesting purposes without considering service performed for any other participating employer.
   E. Annual additions attributable to all participating employers must be considered when determining an individual's maximum annual addition.

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

1.08: Solutions to True or False Questions

1. True
2. True
3. True
4. True
5. True
6. False. The right to hire or fire is not a relevant factor in determining primary direction or control. It is, however, relevant in determining the common law employer and may indicate that the individual is a common law employee of the recipient, and not a leased employee.
7. True
8. True
9. True
10. True

1.09: Solutions to Sample Test Questions

1. The answer is **E**. There is no requirement that an individual be covered by a plan in order to be considered a leased employee.
2. The answer is **E**. Leased employees are treated similarly to employees for nondiscrimination purposes, but it appears to be the IRS's view that leased employees may not participate in an ESOP maintained by the recipient company or any member of its controlled group.
3. The answer is **C**. Statement I and II are true. Statement III is false. Each participating employer may deduct the amount contributed by such organization.
4. The answer is **D**. It is not relevant whether the recipient has the right to hire or fire the individual.
5. The answer is **D**. In a multiple employer plan, service with all participating employers, even if unrelated, must be considered when determining a participant's vested service.

CHAPTER 2:

OTHER EMPLOYER SITUATIONS

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2.01: Key Terms

- C corporation
- Earned income
- Employer
- General partnership
- Guaranteed payments
- Limited liability company (LLC)
- Limited liability partnership (LLP)
- Owner-employee
- Partnership
- Qualified separate line of business (QSLOB)
- S corporation
- Self-employed individual
- Sole proprietorship

2.02: Introduction

When administering plans that are filing their taxes as unincorporated entities, consideration must be given to self-employed individuals, their earned income, and how contribution allocations are determined for such individuals. This chapter outlines these issues. In addition, when the business entity is something other than a corporation, special issues can arise. This chapter outlines some of those issues, including definitions of compensation, procedures needed for the business entity to take action, such as adopting or amending a plan, and what is a qualified separate line of business.

2.03: C Corporations

The standard corporate form that is commonly considered prior to establishing a business is a C corporation. A **C corporation** is a separate entity from its individual owners for tax purposes. Its owners recognize no items of income or loss based on corporate profits or losses. Its owners are not personally responsible for the liabilities of the corporation. If the corporation wants to share some of its gains with its shareholders, it may issue a dividend. The payment of the dividend is not a tax deduction to the corporation, but it is taxable income to the shareholders.

If You're Curious …

A corporation is run by its board of directors. The board is appointed or elected by the shareholders. The board then appoints officers to be responsible for the daily operation of the company. The corporation's articles of incorporation and bylaws outline the manner in which the corporation operates, what duties are delegated by the shareholders to the board, and by the board to the officers. Generally, when the corporation acts, it is by a resolution of the board of directors.

Resolutions of the board of directors occur in three different ways. First, there is an annual meeting that is scheduled in the bylaws of the corporation. This is a "general" meeting, meaning that discussion is open for any topics that the board wants to discuss. No advance notice is required to be given to the board members regarding the topics to be discussed. Resolutions may be presented at the meeting for a vote, and a majority vote

> will commonly be sufficient for the resolutions to be adopted. Sometimes a larger majority is needed, as outlined in the bylaws of the corporation.
>
> The board may also call special meetings when needed. State law generally requires that advance notice of these meetings be provided to all board members, and that the topics to be discussed be disclosed in that notice. Again, simple majorities are generally needed for the adoption of a resolution at a special meeting, although a different majority could be required based on the corporation's bylaws.
>
> Finally, when meetings are inconvenient, the board may act by unanimous written consent. Under this type of resolution, each director signs a written document under which he or she agrees with the adoption of that resolution. If one or more directors do not agree, he or she may refuse to sign the consent, and the resolution may be held over to a meeting of the board, or simply abandoned as unapproved.

Often, a board does not want individuals outside of the board to know about certain confidential resolutions. When a third party wants confirmation that a resolution has been adopted, it is common for the corporate secretary to provide the third party with a certified copy of the specific resolution at issue rather than a copy of the minutes of the meeting at which the resolution was voted upon. This is simply a confirmation of a resolution approved by the board of directors, and must be supported by an actual meeting vote or unanimous written consent document. Sometimes, board members receive compensation for their services on the board. This does not make them employees. Only the salary income that is subject to W-2 reporting may be used as compensation for qualified plan purposes. See Chapter 4, "Compensation," for more details regarding this topic.

2.04: Types of Unincorporated Entities

Corporations have long been a favored form of business operation, significantly due to the fact that the corporate form protects the owners from experiencing personal liability for errors made by workers or harm sustained by the public in relation to the business. However, when a business is sold, having it structured as a corporation may be detrimental to the owners for tax reasons. In many situations, the tax ramifications of a business sale are much more favorable if the business is unincorporated.

As a result, there has been an increasing popularity of many unincorporated business structures, including S corporations, limited liability companies (LLCs) and limited liability partnerships (LLPs). These business forms permit smaller companies and professional corporations to experience many of the positive tax aspects of unincorporated entities, while retaining the liability protection of a corporation. Therefore, the business owners have the best of both worlds.

Owners of unincorporated entities are generally referred to as **self-employed individuals** or **owner-employees**. These include sole proprietors, partners in a partnership and members of a limited liability company, as described below.

SOLE PROPRIETORSHIPS

A sole proprietorship is an unincorporated business that is owned by only one person. The owner is called the *sole proprietor* or the *proprietor*.

The income and expenses of the business are shown on the proprietor's personal tax return, on Schedule C of Form 1040. The net result (i.e., income or loss) will flow from the Schedule C onto the proprietor's personal Form 1040. Therefore, the proprietor gets the benefit of any deductible business expenses and will pay income taxes on any net income of the business.

Any deduction that is being taken for contributions to a qualified plan on behalf of the employees will be shown on the Schedule C and will flow through to the proprietor's Form 1040 as part of the net income or loss. On the other hand, any deduction that is taken by the proprietor for the contribution for his or her own benefit will be shown on line 28 of the Form 1040. Furthermore, the proprietor will be charged on his or her Form 1040 for both the employer and employee side of Social Security (FICA) taxes, generally called self-employment taxes. The proprietor's compensation for qualified plan purposes will be his or her "earned income." This term will be discussed below.

Because a sole proprietorship's net income passes through for tax purposes to the sole proprietor's individual taxes, the business is disregarded for tax purposes—that is, it is not considered to be a separate entity for tax purposes. Unincorporated businesses are also referred to as pass-through entities, for the same reason.

An independent contractor performing services for one or more other companies might be a sole proprietor who, in such a capacity, is engaged in a trade or business that generates earned income. As a sole proprietor, the independent contractor may establish a qualified plan in which the independent contractor is a covered employee. The IRS has established 20 factors and three categories of control to determine proper classification of an individual as an independent contractor.[1] Improper classification could result in a determination that an individual is a common law employee of an employer and not eligible to sponsor a qualified plan as a sole proprietor.

PARTNERSHIPS

A **partnership** is an unincorporated business that is owned by more than one individual. There are three kinds of partnerships: general partnerships, limited partnerships (LPs), and limited liability partnerships (LLPs).

General Partnerships

In a **general partnership**, all of the partners are equally liable for any of the debts of the partnership, and any partner may take action on behalf of the partnership without the approval of the other partners. The profits and losses of the partnership may be spread among the partners equally, or different partners may be assigned different profits or equity interests through the partnership agreement.

EXAMPLE 2-1. Partnership Information. JS and JW form a partnership, J&J. JS is providing all the money to form J&J, and will be a silent partner, not involved in the daily operations. JW is going to be doing all the work and will hire and manage all employees. The partnership agreement provides that, until

[1] Rev. Rul. 87-41.

such time as JS recoups the investment, JS gets all profits. During that period, the partners split net losses 50/50. Once JS has recouped the investment, the profits get split 50/50. Although partners usually split profits and losses equally, the partnership agreement in this case modifies that contractually.

The partnership must file a Form 1065 each year, which is an informational return only. The partnership pays no taxes, as it is a disregarded entity for tax purposes. Each partner's share of the business income and expenses is reported each year on a Schedule K-1, which is attached to the partner's Form 1040. The net income or loss from the Schedule K-1 flows onto the Form 1040. Deductions for qualified plan contributions for employees are shown on the Schedule K-1, and are part of the net income or loss that flows to the partner's tax return from that form. The deduction for qualified plan contributions for a partner is shown on that partner's own Form 1040, line 28. Furthermore, each partner will pay his or her own self-employment taxes. Therefore, partnerships are pass-through entities, and are disregarded for tax purposes. The partner's compensation for plan purposes will be his or her earned income.

A general partnership automatically dissolves upon the withdrawal or death of any partner. The business may be reformed as a successor partnership with any remaining partners, or with any new partners that join up at any time.

Limited Partnerships

Look again at **EXAMPLE 2-1**. It is not unreasonable that JS, the "money person," would hesitate to invest in a business if he was to be fully liable for any debts, errors or accidents caused by JW. JS may want to find a way to limit his or her liability through the structure of the business. However, there may be other tax or business reasons why a partnership structure is favorable.

Most states by statute have established a business entity form called a limited partnership. Under these statutes, an individual who simply invests money and does not get involved in the daily management or performance of duties in a partnership may be a limited partner, while the active participant is the general partner. In that circumstance, the limited partner's liability is limited to his or her equity in the partnership.

EXAMPLE 2-2. Limited Partnership. Suppose that JS's investment in J&J was $100,000, and JS is a limited partner in the partnership. Two months after the business was formed, customer M slips and falls on the business premises, cracking M's spine. M sues the business and receives a court-ordered judgment of $500,000. JS's liability is limited to the value of JS's equity ownership of the business. JS cannot be forced to pay additional amounts out of pocket. The remainder of the judgment must be collected, if possible, from JW.

Because the limited partner may not be involved in the operations of the business, he or she will not be an employee or have active employment income from the business. In other words, there is no earned income, only the passive income that comes from a financial investment. Therefore, the limited partner may not be a participant in any qualified retirement plan that is sponsored by the business.

As with a general partnership, the income and expenses of the business will pass to the partners on Form K-1, as dictated by the limited partnership agreement. The general partner's deduction for contributions to a qualified plan on his or her own behalf will be shown on the partner's Form 1040. The general partner will also be liable for self-employment taxes.

Limited Liability Partnerships

Most states have enacted statutes to permit businesses to be formed as limited liability partnerships (LLPs). An LLP must register with the state by filing the appropriate document. The LLP must be organized for profit, and it must be subject to dissolution upon the withdrawal or death of any partner to the same extent as a general partnership. The partners of the LLP are treated as general partners, so that they are equally responsible for managing the business, engaging in contracts, and sharing in profits and losses (unless the partnership contract modifies this equal allocation).

Like general and limited partnerships, LLPs generally will be treated as partnerships for federal tax purposes. The LLP can elect, however, to be taxed as a corporation. Generally, how the LLP elects to be taxed will control how it is treated for qualified plan purposes—that is, if it is taxed like a partnership, the partnership rules will apply. If it is taxed as a corporation, the corporate rules will apply.

If the partnership rules apply, each partner will receive a Form K-1 that will have a net income or loss that is entered onto the partner's Form 1040. Any contribution to a qualified plan on behalf of the partner will be shown on his or her Form 1040, and not on the K-1. The partner is liable for self-employment taxes. The LLP would then be disregarded for tax purposes. Partner compensation for plan purposes is his or her earned income.

If the LLP is taxed as a corporation, the corporate rules will apply.

LIMITED LIABILITY COMPANIES

A **limited liability company** (LLC) is a contractual arrangement among the owners (known as members) of the company, affording limited liability like a corporation but also providing the freedom to establish ownership and management relationships. Each state has adopted its own unique statute. The LLC may be operated by its members or by managers elected by the members. (Under some states' statutes, managers may be referred to by a different designation, such as governors or authorized persons.)

An LLC with two or more owners may elect to be taxed as a corporation or as a partnership for federal tax purposes. If no election is made, the default classification is a partnership. An LLC with a single owner may elect to be taxed as a sole proprietorship or as a corporation.[2] If no election is made, the LLC is taxed like a sole proprietorship. A member may be an individual, or it could be another entity, such as a corporation.[3] If the LLC does not elect to be taxed as a corporation, the LLC is disregarded for tax purposes, and the net income flows through to the members.

[2] Treas. Reg. §301.7701-3(b).
[3] Treas. Reg. §301.7701-3.

The status of an LLC for federal tax purposes will determine its status for qualified plan purposes. If the LLC is treated as a partnership for tax purposes, then the members are treated as partners. If the LLC is taxed as a corporation, the corporate rules for qualified plans would apply.

S CORPORATIONS

S corporations are not really unincorporated entities. However, they are being discussed in this section because they are corporations that are treated like partnerships for tax purposes.

An **S corporation** is a corporation that has made an election to be taxed like a partnership. The S corporation is disregarded as an entity for tax purposes, and the net income of the corporation flows through to the individuals who own stock in the corporation, called shareholder-employees.

There are some strict limitations on whom or what can form an S corporation:[4]

- They may have no more than 100 shareholders.
- None of the shareholders may be other entities or trusts (although there are many exceptions to the trust exclusion, including employee stock ownership plans (ESOPs) and certain IRAs that held stock in a banking corporation when it became an S corporation).
- No nonresident aliens may be shareholders.
- S corporations generally may have only one class of stock.

There are two types of income that may be earned by a shareholder-employee in an S corporation:

A. Salary – As with other corporations, shareholders may be employees of the S corporation and may be paid compensation as an employee, subject to W-2 reporting.
B. The allocation of the net profit of the S corporation to the shareholder-employee in his or her role as a shareholder. This allocation is similar to a dividend, although because the S corporation is a pass-through organization, the shareholder may not actually receive the income in cash; it simply flows to him or her when the S corporation is disregarded for tax purposes.

Only the salary income may be used as compensation for qualified plan purposes, because it is the only portion that is considered to be attributable to the personal services provided by the shareholder-employee.

The reporting of the deductions for qualified plan contributions in an S corporation is similar to that of a partnership. The S corporation files its own informational return on a Form 1120S. Each shareholder-employee is provided with a Schedule K-1, which reflects his or her share of the allocable income or loss from the corporation. Unlike partnerships, however, the Schedule K-1 will reflect the shareholder-employee’s share of the qualified plan contributions for the non-owners plus the shareholder-employee’s own share of the contributions. The shareholder-employee’s own contribution is not entered as a separate item on his or her Form 1040, but simply flows through from the net income reflected on the Schedule K-1.

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[4] IRC §1361(b).

CODE SECTION 199A DEDUCTION RULES

The Treasury Department and the IRS proposed regulations on August 8, 2018 and finalized them in January of 2019, on the deduction for qualified business income under the new Code Section 199A.

Enacted as part of the Tax Cuts and Jobs Act (TCJA), the new Section 199A provides a deduction of up to 20 percent of income from a domestic business operated as a sole proprietorship or through a partnership, S Corporation, trust or estate engaged in domestic trades or businesses. The deduction is available for tax years beginning after Dec. 31, 2017, and will expire in 2026 unless it is extended by Congress. The deduction is generally available to eligible taxpayers whose 2018 taxable incomes fall below $315,000 for joint returns and $157,500 for other taxpayers. It's generally equal to the lesser of 20 percent of their qualified business income, plus 20 percent of their qualified real estate investment trust dividends and qualified publicly traded partnership income or 20 percent of taxable income minus net capital gains.

The proposed regulations do allow a de minimis exception to mitigate compliance costs for businesses earning only a small percentage of SSTB income. Under the proposal, minimal standards are set for businesses with $25 million or less in gross receipts. As such, the proposal disregards SSTB income if it totals less than 10 percent of these gross receipts. For businesses in excess of $25 million in gross receipts, the rules disregard SSTB income if it comprises less than 5 percent of those gross receipts.

In addition, the proposed regulations:

1. Contain an anti-avoidance rule under Code Section 643 to treat multiple trusts as a single trust in certain cases; and
2. Seek to establish anti-abuse safeguards to prevent improper tax avoidance schemes, such as relabeling employees as independent contractors.

2.05: Earned Income

Earned income is a term used to define the compensation of a self-employed individual.[5] If a plan covers self-employed individuals, the definition of *compensation* in the plan document must include a definition of *earned income* in order for self-employed individuals to share in compensation-based allocations. The *earned income* definition should be included where compensation is otherwise used for qualified plan purposes, except where adjustments to earned income are specifically required. Earned income is used as compensation for IRC §415 purposes, to determine allocations, for calculating the deduction limit under IRC §404, and for nondiscrimination testing purposes.

NET EARNINGS FROM SELF-EMPLOYMENT

An individual's earned income is his or her net earnings from self-employment.[6]

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[5] IRC §401(c)(2).
[6] IRC §1402(a), with the modifications described in IRC §401(c).

An individual's net earnings from self-employment is defined in the IRC to be "the gross income derived by an individual from a business carried on by such individual, less the deductions that are attributable to such business, plus his or her allocable share of income or loss of the unincorporated business."[7] The deductions that reduce the net earnings from self-employment and the earned income include one-half of the self-employment taxes and contributions made to a qualified plan. The IRC also excludes certain types of income and expenses from the calculation of the net earnings from self-employment.

The net earnings from self-employment are reported on the Schedule C (line 31) or Schedule C-EZ (line 3) in the case of most sole proprietors, or on the Schedule K-1 (line 14) in the case of partners of partnerships (or entities such as LLCs, that are taxed as partnerships). This amount is then subject to the following adjustments:[8]

- IRC §179 expense deduction. To arrive at earned income for a general partner, the depreciation allowance under IRC §179 is subtracted from the net earnings reported in line 14a of the Schedule K-1;[9] and
- Other line 14 adjustments. The instructions to line 14 of Schedule K-1 also require the amount reported on line 14 for a general partner to be reduced by unreimbursed partnership expenses claimed by the partner, as well as expenses for depletion on oil and gas properties. These are the same additional expenses that are subtracted from line 14 to determine the amount reported on line 1 or line 2 of the Schedule SE.

Earnings Must be Attributable to Personal Services

Only earnings from a trade or business in which the individual's personal services are a material income-producing factor are included in earned income.[10] 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.

Earned income includes only 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.[11]

Guaranteed payments, as defined in 5 below, made to a partner of a partnership are taken into account in computing net earnings from self-employment, but only to the extent the guaranteed payments are for services rendered to the partnership.[12]

A limited partner might have net earnings from self-employment, but only to the extent the limited partner's distributive share of partnership income (including guaranteed payments, if any) is

[7] IRC §1402(a).
[8] IRC §401(c)(2).
[9] See instructions to line 15a of the Schedule K-1.
[10] IRC §401(c)(2)(A)(i).
[11] IRC §401(c)(2)(B).
[12] Treas. Reg. §1.1402(a)-1(b) and IRS Publication 560.

attributable to personal services rendered to the partnership. In many (if not most) cases, a limited partner does not provide personal services to the partnership.

Self-Employment Tax Deduction under IRC §164(f) is Taken into Account

Earnings are reduced by the deduction allowed under IRC §164(f) for one-half of the individual's self-employment tax[13] to arrive at the adjusted net earnings from self-employment.

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 individual.[14] For example, if an individual's earned income without a qualified plan deduction would be $60,000, but the IRC §404 deduction is $10,000, the individual's earned income is only $50,000. The $50,000 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 $50,000 amount is also used to determine whether the contribution satisfies the nondiscrimination requirements of IRC §401(a)(4).

If the Employer is a	Then
Sole Proprietorship	The entire IRC §404 deduction for the year will reduce the earned income of the sole proprietor.
Partnership (or an entity taxed as a partnership)	The IRC §404 deduction is allocable among the partners. Thus, for each partner, the IRC §404 deduction taken into account 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.
Sole proprietorship or partnership maintains more than one plan	The combined qualified plan deduction allowed to the employer is taken into account in determining the self-employed individual's earned income. That earned income amount is then used by all of the plans.*
Sole proprietorship or partnership has common law employees who are covered by the plan	The qualified plan deduction under IRC §404 that is taken into account to compute earned income includes the contributions made on behalf of such employees (or, in the case of a partner, the partner's allocable share of the deduction attributable to such contributions), including the pre-tax elective contributions and pre-tax catch-up contributions made by such common law employees to a 401(k) arrangement maintained by the employer. Remember, the pre-tax elective contributions and pre-tax catch-up contributions made by the employees are deductible by the employer in full, so the IRC §404

[13] IRC §401(c)(2)(A)(vi).
[14] IRC §401(c)(2)(A)(v).

	deduction that reduces the earned income of the sole proprietor or the earned income of the partners will include the employees' 401(k) deferrals that are deductible.**
* IRC §401(c)(2)(A)(v). ** IRC §404(a)(12).	

Any designated Roth contributions or Roth catch-up contributions would not be taken into account, as they are not deductible under IRC §404. (They are deducted by the employer as part of the employees' compensation under a different IRC section.)

Earned Income Grossed Up for IRC §415 and §404 Purposes

For purposes of determining compensation under IRC §415, a self-employed individual's earned income is grossed up for pre-tax elective deferrals and pre-tax catch-up contributions under a 401(k) plan that were made by that self-employed individual (which would have been reflected in the IRC §404 deduction). The gross-up for the self-employed individual's own deferrals places his or her earned income for IRC §415 purposes on par with the compensation taken into account for a common law employee (including a shareholder of a corporation who is also an employee covered by the plan). If the plan uses IRC §415 compensation for other purposes (e.g., allocation of employer contributions, nondiscrimination testing), the self-employed individual's earned income also will be grossed-up by his or her deferrals for those purposes.

Grossed up compensation is also used to calculate the applicable deduction limits under IRC §404.[15] The self-employed individual's earned income is grossed up for his or her own pre-tax elective deferrals and pre-tax catch-up contributions (but not for other employer contributions) before determining the maximum deductible employer contribution under IRC §404. This rule will provide more room for making deductible contributions on behalf of self-employed individuals.

Guaranteed Payments

Sometimes a partnership agrees to pay certain minimum payments to one or more partners. These partners then receive the greater of these minimum payments (which are called **guaranteed payments**) or their distributable share of the partnership's net income. If the guaranteed payments are more than the partnership's distributable net income, the other partners will end up with a larger share of the loss than they would experience if there were no guaranteed payments.

Guaranteed payments are taken into account in computing a partner's net earnings from self-employment. The partnership calculates its gross income and deductions by treating the guaranteed payments as payments to a nonpartner, but for all other purposes the guaranteed payments are treated as part of the partner's distributable share of partnership income. It is possible that a partner's earned income may be less than the guaranteed payments. That would occur if the partnership income suffers a loss or earns less than it has paid out in guaranteed payments. When guaranteed payments are added to the partner's distributable share of the partnership loss, the

[15] IRC §404(a)(12).

resulting net earnings from self-employment would be less than the amount of the guaranteed payments.[16]

EXAMPLE 2-3. Guaranteed Payments. S and A are partners in the SA partnership. As part of the partnership agreement, the two agree to split profits 50/50, but S agrees that A will get guaranteed payments of $5,000 per month, for a total of $60,000 per year. These amounts are paid to A during the year. At the end of the year, the accountant determines that the net income of the partnership is:

• $200,000 of income; less

• $100,000 of deductible expenses,

for a net income of $100,000. The guaranteed payments are then deducted from that for a final net income of $40,000. This net is allocated 50/50 (or $20,000 each) to the partners. The total of A's earnings from self-employment is $80,000 (the $60,000 of guaranteed payments, plus the $20,000 allocable share of the partnership net income). S's net earnings from self-employment are $20,000 (i.e., S's share of the allocable net income of the partnership).

EXAMPLE 2-4. Guaranteed Payments Exceed Earned Income. Suppose the same facts as above, except the income and expenses of the partnership are:

• $200,000 of income; less

• $150,000 of deductible expenses,

for a net income of $50,000. The guaranteed payments are then deducted from that for a final net loss of $10,000. This is allocated 50/50 (or $5,000 each) to the partners. A's total earnings from self-employment are then $55,000 (the $60,000 of guaranteed payments, minus the allocable share of the partnership net loss of $5,000). S's net earnings from self-employment are a loss of $5,000.

CHANGE IN STATUS FROM EMPLOYEE TO PARTNER

It is possible that, within a plan year, an employee might become a partner in the partnership that maintains the plan. As a result, the individual is an employee for a portion of the year and a self-employed individual for the rest of the year. In that case, the compensation taken into account under the plan will be the sum of the individual's compensation as an employee plus his or her earned income as a partner.

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[16] IRC §707(c), Treas. Reg. §1.707-1(c).

DIRECTOR'S FEES

Serving as a director of a corporation is a trade or business and the director's fees constitute self-employment income.[17] This means the director is treated as owning a sole proprietorship in which his or her earned income is derived from his or her activities as a director. The sole proprietorship may establish a qualified plan that covers the individual as a self-employed individual, where compensation is determined as the individual's earned income derived from his or her director activities.

The corporation that pays the director's fees is not the employer of the director with respect to that income. Thus, the corporation's qualified plan could not treat the director as receiving compensation from the corporation with respect to those director's fees. Unless the director receives compensation as an actual employee of the corporation, the director would not be eligible to participate in the corporation's plan.

Remember, however, that the business derived from an individual's director activities might be part of a controlled group of businesses if the individual has ownership in other businesses.

S CORPORATION SHAREHOLDERS

Although an S corporation shareholder receives dividends similar to a partner's distributions from a partnership, the shareholder's dividends do not constitute earned income for qualified plan purposes, because the S corporation is not the type of employer that can have self-employed individuals as defined in IRC §401(c)(1). As a consequence, the S corporation shareholder may not establish a plan by himself as a self-employed individual.[18] The shareholder's compensation for qualified plan purposes is determined in the same manner as any other common law employee (i.e., W-2 compensation).

EXAMPLE 2-5. S Corporation. W is a shareholder of an S corporation. For the current year, W received no W-2 compensation from the corporation. W's income derived from the S corporation is reported entirely on the Schedule K-1. W has no compensation for the year for purposes of any qualified plan maintained by the S corporation.

MEMBERS OF LIMITED LIABILITY COMPANIES

A member or owner of a limited liability company (LLC) has earned income if the LLC is taxed as a partnership for federal tax purposes. If an LLC is taxed as a partnership, its members are treated as self-employed individuals. If an LLC is taxed as a corporation, then the owners will need to receive compensation as common law employees in order to have eligible compensation for qualified plan purposes.

[17] *Steffens v. Commissioner*, 707 F.2d 478 (11th Cir. 1983).
[18] *Durando v. U.S.*, 70 F.3d 548 (9th Cir. 1995), PLR 8716060.

SEPARATE DETERMINATION FOR EACH TRADE OR BUSINESS

If a self-employed individual is engaged in more than one trade or business, the earned income of each trade or business is determined separately.[19] For example, if one business produces earned income of $50,000, and the other business produces a loss of $60,000, the individual does not net the earned income of the two businesses. The $50,000 of earned income from the first business may be used to support a qualified plan contribution. When computing a self-employed individual’s contribution under a qualified plan, only the earned income from the business or businesses maintaining the plan is included.[20] When an individual has more than one trade or business, the IRC §164(f) deduction for self-employment taxes must be prorated among the businesses, and only the prorated portion is subtracted from the net earnings of each business to arrive at earned income for that business.[21]

2.06: Plan Requirements for Self-Employed Individuals

DEFINITION OF EMPLOYER FOR ERISA PURPOSES

Pursuant to the Employee Retirement Income Security Act of 1974 (ERISA) as amended, §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 a capacity. A sole proprietorship or partnership is an employer for ERISA purposes only with respect to its common law employees. For ERISA purposes, the sole proprietor or the partners are not treated as employees.

UNINCORPORATED EMPLOYER MUST ESTABLISH THE PLAN

Remember, an employer must establish a qualified plan. For a self-employed individual, the employer is the sole proprietorship or the partnership, as the case may be.

CONTRIBUTION ALLOCATIONS FOR SELF-EMPLOYED INDIVIDUALS

Sample Profit-Sharing Plan Allocation

SP is a sole proprietor of an unincorporated business and has two employees. SP’s earned income (determined with all adjustments required by IRC §401(c), including the IRC §164(f) deduction for one-half of self-employment taxes, but excluding the qualified plan deduction) is $90,000. The

[19] Treas. Reg. §1.401-10(b)(2).
[20] IRC §401(d).
[21] Announcement 94-101, which provides the IRS’ audit guidelines for deduction calculations for self-employed individuals.

W-2 wages of the two employees for the current plan year are $18,000 and $25,000. SP maintains a profit-sharing plan that covers SP and the two employees. The employer contribution is allocated under a pro rata allocation method (i.e., in proportion to compensation). As a self-employed individual, SP is wearing two hats—one as the employer maintaining the plan (i.e., the sole proprietorship) and one as a participating employee (i.e., the self-employed individual with respect to the sole proprietorship that maintains the plan). As employer, SP makes a contribution to the profit-sharing plan for the plan year in the amount of $10,000. SP, as the employer, is entitled to an employer contribution deduction of $10,000 under IRC §404. This deduction reduces SP's earned income for plan purposes to $80,000. This reduced earned income of $80,000 must be used to determine SP's share of the contribution under the plan.

The following allocations would be made to the account balances of the three plan participants.

Employee	Plan Compensation	Allocable Share	Allocation Amount
SP	$80,000	80/123 × $10,000	$6,504
Employee #1	$25,000	25/123 × $10,000	$2,033
Employee #2	$18,000	18/123 × $10,000	$1,463
Total	$123,000	123/123 × 10,000	$10,000

If SP had not been required to take into account the IRC §404 deduction, SP's earned income would have been $90,000 and would have received a greater share of the total allocation.

There are several ways to determine the employer's contribution. One is for the employer to arrive at the total contribution amount, and then back into the relative allocations. If $10,000 is the desired contribution, then SP's net earnings from self-employment are reduced by the $10,000 deduction, and the resulting earned income of $80,000 is plugged into the plan's allocation formula to determine each participant's allocable share of the contribution. Another option is for SP, as the employer, to determine the contribution, as a percentage of compensation for the two employees, and calculate the amount of contribution that would equal such percentage. SP's net earnings from self-employment are then reduced by the contribution to be made for the two employees. Because the plan's allocation method is pro rata, SP's allocation has to be the same percentage of SP's earned income. The contribution is "solved for" using the formula approach discussed below for a money purchase pension plan contribution.

Sample Money Purchase Pension Plan Contribution

Suppose SP maintains a money purchase pension plan instead of the profit-sharing plan. The contribution formula is 5 percent of compensation. The contribution required for the two employees would be 5% × $25,000, or $1,250, for employee #1, and 5% × $18,000, or $900, for employee #2. The combined contribution for both employees is $2,150, which would be a deduction against SP's earned income. This would reduce SP's earned income from $90,000 to $87,850. However, SP's 5 percent money purchase pension plan contribution is not 5% × $87,850 because the contribution allocated to SP's account is also part of the qualified plan deduction and further reduces SP's earned income for allocation purposes. The algebraic formula below is used to compute SP's contribution, where "X" is SP's money purchase pension plan contribution.

$$\begin{aligned} X &= 5\% (\$87{,}850 - X) \\ X &= \$4{,}392.50 - .05X \\ 1.05X &= \$4{,}392.50 \\ X &= \$4{,}392.50/1.05, \text{ or } \$4{,}183.33 \end{aligned}$$

SP's allocation of $4,183.33 is an additional deduction against SP's income, so the true earned income for allocation purposes is $83,666.67 (i.e., $87,850 – $4,183.33). The allocation represents 5 percent of that true earned income (i.e., 5% × $83,666.67 = $4,183.33).

If the allocation formula is a level percentage of pay, the above formula can be adjusted to figure out the sole proprietor's net earned income. If the percentage of pay to be allocated is X (expressed as a decimal, such as .10 for 10 percent), the formula is:

$$\text{Net earned income} = \frac{\text{gross income minus employees' share of contribution}}{(1 + X)}$$

The contribution is then equal to the net earned income multiplied by the contribution percentage.

Effect of Forfeitures

When there are forfeitures in a defined contribution plan, the plan might reduce the employer's required contribution under the plan by the amount of the forfeitures. This is known as the reduction method for allocating forfeitures because the employer contribution is reduced by the amount of forfeitures allocated for the plan year. When a self-employed individual is sharing in the allocation, the reduction of the employer's contribution by the amount of the forfeitures will, in turn, reduce the deduction being taken by the self-employed individual (i.e., because the employer contribution is smaller). The reduced deduction increases the self-employed individual's earned income and, thus, his or her allocation amount. In the money purchase pension plan example above, suppose there are forfeitures in the amount of $2,000 that are allocated among the eligible participants, and the plan provides that the employer's required contribution be reduced accordingly. SP's earned income will be more than $83,666.67 after the contribution deduction is taken into account because the employer (i.e., SP, as the sole proprietor) is contributing an amount that is less than 5 percent of compensation due to the use of the forfeitures as part of the contribution amount. This interrelated effect that the forfeitures have on SP's earned income must be taken into account to compute SP's 5 percent contribution allocation.

Other Types of Allocation Methods

The above examples illustrate only one of many ways the plan might provide for the allocation of the contribution. In other allocation methods, SP's earned income would be the net earnings after the qualified plan deduction is taken into account (including the deduction for the portion of the contribution that is allocated to SP). If two plans are maintained, the deductions under both plans affect SP's earned income for allocation purposes under each plan.

The algebraic formula shown above would apply to determine the self-employed individual's allocation whenever that allocation is expressed as a percentage of earned income, or to "back into" or "solve for" SP's allocation based on a pre-determined allocation rate for the other employees. In the profit-sharing example above, suppose SP wanted to calculate a 15 percent profit-sharing contribution for SP and the employees:

1. Calculate 15 percent of SP's two employees' compensation,
2. Subtract that amount from SP's net earnings from self-employment,
3. Use the algebraic formula (substituting 15 percent for 5 percent in the example above) to arrive at the contribution to be made on SP's behalf.

If the formula is not a uniform percentage for all participants (e.g., a permitted disparity formula), the algebraic formula must be adjusted accordingly to take into account the applicable formula percentage for each participant. The more complex the allocation formula, the more complex the algebra becomes to determine the sole proprietor's compensation and allocation.

Elective Deferrals Made by a Self-Employed Individual

A self-employed individual might be covered under a 401(k) plan. The elective deferrals (this includes pre-tax elective deferrals, designated Roth contributions and catch-up contributions) the self-employed individual elects under the 401(k) arrangement would be allocated to his or her account, just like the elective deferrals made by the common law employees. If elective deferrals are made through salary reduction agreements, the self-employed individual must also execute such an agreement to make elective deferrals. An election may apply only to compensation that is not already currently available at the time of the election. For a self-employed individual, the earned income is not treated as currently available until the end of the taxable year for which such income is calculated. Therefore, the individual can make a deferral election up to the last day of the plan year and still have it apply to all of the earned income for that year.

For example, suppose a partnership maintains a 401(k) plan with a plan year ending December 31. The partnership's taxable year ends December 31. For each year ending December 31, any eligible partner can make a deferral election from his or her earned income for that partnership year by making that election no later than December 31 of that year.[22]

The IRS has ruled that elective deferrals may be made from advances ("draws") to partners of their distributive share of partnership earnings, because the advances are being made before the earned income is made available.[23] In addition, regulations that generally prohibit an employer from "prefunding" elective deferrals before they are earned by the participant, allow for advances to partners to be contributed to the plan as elective deferrals without violating that prefunding rule.[24] As a cautionary note, however, advances being treated as representative of a partner's distributive share of earnings should be determined on a conservative basis, particularly where elective contributions are being withheld, because the ultimate earned income under IRC §401(c) will not be determinable until the end of the partnership taxable year. It is possible that the final earned income will not be sufficient to support the level of deferral withheld from the partner's advances

[22] Treas. Reg. §1.401(k)-1(a)(6).
[23] PLR 200247052.
[24] Treas. Reg. §1.401(k)-1(a)(6)(iv).

during the year, or might result in a much higher deferral percentage for discrimination-testing purposes than might have been anticipated.

EXAMPLE 2-6. Sole Proprietorship Sponsors a 401(k) Plan. Company J (a sole proprietorship) sponsors a 401(k) plan that covers both the employees and the sole proprietor, JS. JS's earned income for 2019 (determined with all adjustments required by IRC §401(c), including the IRC §164(f) deduction for one-half of self-employment taxes, except for the qualified plan deduction) is $200,000. JS's employees deferred $10,000 of their W-2 compensation to the 401(k) plan and Company J contributes $5,000 (a 5 percent profit-sharing contribution) on their behalf. Furthermore, JS makes a $25,000 pre-tax elective deferral ($19,000 pre-tax elective deferral and $6,000 pre-tax catch-up contribution) on JS's own behalf. None of these amounts has been subtracted from the $200,000 earned income number reflected above. What is JS's earned income for plan purposes?

JS's earned income is reduced by the contributions made on behalf of the other employees (pre-tax elective contributions, pre-tax catch-up contributions and employer profit-sharing contributions). It is further reduced by the profit-sharing contribution made on JS's own behalf, but not for JS's pre-tax elective contribution and pre-tax catch-up contributions (which are included in earned income).

Therefore, JS's profit-sharing contribution (X) will be:

X = .05($200,000 − $15,000 – X)
X = .05($185,000) – .05X
X = $9,250 − .05X
1.05X = $9,250
X = $9,250/1.05
X = $8,810 (rounded up)

JS's earned income may then be determined by subtracting the total profit-sharing contribution for both JS and the other employees ($5,000 + $8,810) and the other employees' pre-tax elective contributions and catch-up contributions ($10,000):

Earned Income = $200,000 − $10,000 − $8,810 − $5,000 = $176,190

JS's own 401(k) pre-tax elective contribution and pre-tax catch-up contribution is subtracted from JS's earned income to determine JS's taxable income, which is $176,190 − $25,000 = $151,190.

Application of Compensation Dollar Limit to Earned Income

The compensation limit under IRC §401(a)(17) applies to the self-employed individual's earned income taken into account for allocation purposes. The dollar limit is applied to the earned income that is used for purposes of calculating the contribution. Treas. Reg. §1.401(a)(17)-1(b)(6), Examples 7 and 5, illustrate how a profit-sharing plan contribution for a self-employed individual could be affected by the manner in which the plan defines the earned income used to calculate the contribution. Assume in the examples below that the compensation dollar limit in effect for the applicable plan year is $280,000.

EXAMPLE 2-7. Earned Income Not Above Compensation Dollar Limit After Deductible Contribution is Determined. Suppose the plan provides for a uniform contribution percentage for all participants. For the current plan year, the contribution percentage for the common law employees equals 15 percent of compensation. The plan is maintained by a partnership, so the partners are also covered by the plan. Their earned income is defined in accordance with IRC §401(c)(2), so that the deduction taken for the contribution made on a partner's behalf directly reduces that partner's net earnings from self-employment to arrive at earned income. Thus, the plan provides for the same 15 percent allocation to the partners.

B is a partner who is eligible for an allocation. B's net earnings from self-employment, before the adjustment for the profit-sharing plan contribution, are $285,000. (This amount already reflects the deduction taken under IRC §164(f) for one-half of the self-employment taxes, as well as B's share of the deduction attributable to contributions made for the common law employees.) The contribution is calculated using the same type of algebraic principle discussed above for money purchase pension plans. Applying the algebraic formula,

$$X = 15\% (\$285{,}000 - X)$$
$$X = \$42{,}750 - .15X$$
$$1.15X = \$42{,}750$$
$$X = \$42{,}750/1.15, \text{ or } \$37{,}174$$

the contribution for B is determined to be $37,174. This contribution is a deduction allocated to B, as a partner of the partnership, which reduces the earned income to $247,826.

To test the accuracy of this calculation, the earned income amount of $247,826 is multiplied by 15 percent, yielding the contribution of $37,174. The compensation dollar limit is not violated in this example, even though we started with an amount above $280,000 in the algebraic formula. The earned income used for allocation purposes is $247,826, because that is B's earned income after the deduction for the contribution is taken into account.[25]

EXAMPLE 2-8. Compensation in Excess of Dollar Limit After Contribution is Calculated Under Algebraic Formula. If the earned income remaining after the deduction of the contribution exceeds the compensation dollar limit, the contribution must be adjusted. To illustrate, suppose in the prior example that B's net earnings from self-employment (prior to the deduction taken for B's contribution) is $350,000, rather than $285,000. The algebraic formula would yield a contribution of $45,652.17.

[25] Treas. Reg. §1.401(a)(17)-1(b)(6), Example 5.

$X = 15\% (\$350{,}000 - X)$
$X = \$52{,}500 - .15X$
$1.15X = \$52{,}500$
$X = \$52{,}500/1.15$, or $45,652.17

However, if $350,000 is reduced by $45,652.17, the resulting earned income is $304,347.83, which exceeds the $280,000 compensation dollar limit in effect for the plan year. Therefore, B's earned income first would be capped at $280,000, and the 15 percent profit-sharing contribution made on B's behalf would be $42,000. (B's uncapped earned income would be $308,000, i.e., $350,000 minus the plan contribution of $42,000.)

2.07: Qualified Separate Line of Business

So far in this chapter, we have covered the type of entity (i.e., corporation, sole proprietorship, partnership) for which an employer elects to do business. An employer may also designate its lines of business by reference to the property or services provided to customers of the employer.[26] This designation is called a **qualified separate line of business** (QSLOB) in IRC §414(r).

If the requirements for QSLOB are met, an employer may elect to apply the coverage tests under IRC §410(b), and, as a result, the nondiscrimination tests of IRC §401(a)(4) separately to each QSLOB. In other words, the purpose of making a QSLOB election is to perform certain testing requirements on a QSLOB-basis rather than on an employer-wide basis. In order to perform the coverage (and thereby nondiscrimination testing) separately, the plan must first satisfy the nondiscriminatory classification requirement of the coverage test under IRC §410(b) on an employer-wide basis.[27]

Even though the QSLOB rules apply for coverage and nondiscrimination, the separate lines of business are still treated as part of a single-employer for purposes of all other qualification rules, such as the crediting of service for eligibility purposes (IRC §410(a)) or vesting purposes (IRC §411), the contribution and benefits limits under IRC §415, and testing whether plans are top-heavy under IRC §416.

To be a QSLOB, an employer must be divided up into at least two separate lines of business. The lines of business must then meet certain requirements.

REQUIREMENTS OF A SEPARATE LINE OF BUSINESS

To be a separate line of business, the line of business must be organized and operated separately from the remainder of the employer. A line of business must meet the following criteria to be considered a separate line of business:[28]

- Formally organized as a separate unit or group of separate units;
- A separate profit center or group of profit centers and maintains separate books for each profit center for internal planning and control purposes;

[26] Treas. Reg. §1.414(r)-2.
[27] Treas. Reg. 1.414(r)-8(b).
[28] Treas. Reg. §1.414(r)-3(b) and (c).

- Its own workforce where at least 90 percent of the employees providing services to the line of business are substantial-service employees of the line of business, and are not substantial-service employees of other lines of business; and
- Its own management in which at least 80 percent of the top-paid employees of the line of business are substantial-service employees to the line of business.

Separate Lines Do Not Have to Provide Different Products/Services

There is no requirement that each line of business be engaged in a different service line or product line. For example, two lines of business might manufacture the same product. As long as the financial accountability, workforce and management satisfy the separateness requirements, each line can qualify as a separate line of business.

Vertically Integrated Businesses

Vertically integrated businesses are lines of business that include an upstream business and a downstream business. The upstream business is the one that provides property to the downstream business. In some cases, an upstream business will not provide any property or services to customers, but only to the downstream business. As a general rule, a separate line of business must provide property or services to customers. However, Treas. Reg. §1.414(r)-2(b)(2)(i) exempts an upstream business from the requirement to provide services or property to customers if certain conditions are satisfied.

REQUIREMENTS OF A QUALIFIED SEPARATE LINE OF BUSINESS (QSLOB)

To be a **QSLOB**, the separate line of business must satisfy the following requirements:

- Have at least 50 employees;
- Give notice to IRS; and
- Pass administrative scrutiny test.

Each of these elements must be satisfied with respect to each separate line of business. These requirements are determined on a year-by-year basis. Thus, it is possible that an employer is able to demonstrate that it consists of QSLOBs for one testing year, but not be able to demonstrate that it consists of QSLOBs for a subsequent testing year.

50-Employee Requirement

The separate line of business must include at least 50 employees on every day of the testing year.[29] Certain employees excluded from the top-paid group test under the highly compensated employee definition are excluded for purposes of this 50-employee test.

[29] IRC §414(r)(2) and Treas. Reg. §1.414(r)-4.

Notice Requirement

An employer must provide notice to the IRS when it elects to use QSLOB testing, and also when it revokes such an election. The employer files Form 5310-A for both electing to use and revoking QSLOB testing. The election is made by an employer on a "testing year" basis. The testing year for QSLOB purposes is always the calendar year. If non-calendar year plans are being tested using a QSLOB structure, the election applies for all plan years that begin in the testing year.

If Form 5310-A is filed to elect QSLOB testing for a calendar year, that election applies to all subsequent years unless it is revoked, or unless, in a subsequent year, the employer does not meet the requirements for making a QSLOB election. The notice to make a QSLOB election or to revoke a prior election must be given no later than the October 15th following the calendar year for which the election (or revocation) applies. If all the plans maintained by the employer are not on a calendar year, then the 15th day of the 10th month following the close of the plan year that begins earliest in the calendar year is substituted for the October 15 deadline.[30]

Administrative Scrutiny Test

The QSLOB can satisfy administrative scrutiny under one of the safe harbor tests or by IRS determination. All of the employer's QSLOBs are not required to meet the same administrative scrutiny test. For example, if an employer has three QSLOBs, one could be relying on the statutory safe harbor, another could be relying on the mergers and acquisitions safe harbor and the third QSLOB could be relying on the minimum or maximum benefit safe harbor.

Safe Harbor Tests

Treas. Reg. §1.414(r)-5 outlines six safe harbor tests. The QSLOB must satisfy at least one test. As noted above, there is no requirement that all of a company's QSLOB rely on the same safe harbor test.

A. ***Statutory safe harbor.*** This safe harbor test is satisfied if the QSLOB's highly compensated employee (HCE) percentage is not less than 50 percent and not more than 200 percent of the HCE percentage determined on an employer-wide basis.[31] A special exception deems the 50 percent test satisfied if at least 10 percent of all HCEs of the employer perform services exclusively for the QSLOB. For purposes of this test, the QSLOB's HCE percentage ratio is the ratio of the percentage of the QSLOB's employees who are HCEs to the percentage of all employees who are HCEs. For example, assume HCEs represent 10 percent of all employees of the employer and 6 percent of employees of the QSLOB. The HCE percentage ratio would be 60 percent (6 percent divided by 10 percent), and the QSLOB would meet the statutory safe harbor (i.e., the HCE percentage ratio is between 50 percent and 200 percent).
B. ***Different industries safe harbor.*** This safe harbor test is satisfied if the QSLOB is in a separate industry or industries than every other QSLOB of the employer.[32] The IRS has

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[30] Rev. Proc. 93-40, 1993-2 C.B. 535, and the instructions to Form 5310-A.
[31] IRC §414(r)(3).
[32] Treas. Reg. 1.414(r)-5(c).

published a list of industries to aid in determining whether a separate line of business meets this safe harbor.[33]

C. ***Mergers and acquisitions safe harbor.*** This safe harbor test is satisfied if the QSLOB is an acquired line of business that satisfies the separateness requirements of Treas. Reg. §1.414(r)-3, and no more than 10 percent of the employees transfer in or out of the acquired line during the testing year.[34] This safe harbor is available only for a "transition period," which is defined as the testing year (i.e., calendar year) that begins after the date of the acquisition and up to three testing years thereafter.[35]
D. ***Industry segment safe harbor.*** This safe harbor test is satisfied if the QSLOB is reported as one or more industry segments on its annual report (SEC Form 10-K or Form 20-F).[36]
E. ***Average benefits safe harbor.*** This safe harbor test is satisfied if the average benefits provided to the employees meet the regulatory guidelines of Treas. Reg. §1.414(r)-5(f). The applicable average benefits safe harbor test depends upon the reason for failing the statutory safe harbor. If the QSLOB's HCE percentage ratio is less than 50 percent, the actual benefit percentage of the QSLOB's NHCEs must be no less than the actual benefit percentage of all other NHCEs of the employer.[37] If the QSLOB's HCE percentage ratio is greater than 200 percent, the actual benefit percentage of the QSLOB's HCEs must be no greater than the actual benefit percentage of all other HCEs of the employer.[38]
F. ***Maximum or minimum benefits safe harbor.*** This safe harbor test is satisfied if the plans of the QSLOB satisfy a minimum benefit test or a maximum benefit test, whichever applies.[39] Like the average benefits safe harbor, which test applies depends upon the reason for failing the statutory safe harbor. If the QSLOB's HCE percentage is less than 50 percent of the employer-wide percentage, the minimum benefits test must be satisfied. Under this test, at least 80 percent of the NHCEs of the QSLOB must accrue benefits in a defined benefit plan or allocations in a defined contribution plan that at least equal minimum rates prescribed by the regulations. If the QSLOB's HCE percentage is greater than 200 percent of the employer-wide percentage, the maximum benefits test must be satisfied. Under this test, the HCEs of the QSLOB cannot accrue benefits in a defined benefit plan or allocations in a defined contribution plan that exceed maximum rates prescribed by the regulations. This test can be satisfied by averaging the rates of the HCEs, if the average does not exceed 80 percent of the regulatory maximum rate.

[33] Rev. Proc. 91-64, 1991-2 CB 866.
[34] Treas. Reg. §1.414(r)-5(d).
[35] Treas. Reg. §1.414(r)-5(d)(3).
[36] Treas. Reg. §1.414(r)-1(e). Industry segments are determined in accordance with the Statement of Financial Accounting Standards No. 14.
[37] Treas. Reg. §1.414(r)-5(f)(2).
[38] Treas. Reg. §1.414(r)-5(f)(3).
[39] Treas. Reg. §1.414(r)-5(g).

IRS DETERMINATION WHERE SAFE HARBOR TEST IS NOT SATISFIED

If a separate line of business does not satisfy any of the safe harbor tests, it cannot be a QSLOB unless it obtains an IRS determination that it satisfies the administrative scrutiny test.[40] The IRS will consider all facts and circumstances in making this determination. Rev. Proc. 93-41, 1993-2 C.B. 536 outlines procedures for requesting a ruling on the administrative scrutiny test and lists relevant factors that will be considered by the IRS in determining whether the QSLOB rules will apply.

2.08: Review of Key Concepts

- What are the different types of business entities?
- Identify distinguishing characteristics of sole proprietorships, partnerships, limited liability companies, S corporations and C corporations.
- What is earned income?
- How is earned income used for qualified plan purposes?
- Given a set of facts, calculate earned income for plan purposes.
- What is a QSLOB?
- How does a QSLOB impact plan testing?
- Identify the six safe harbor tests that a QSLOB can use to satisfy the administrative scrutiny test.

2.09: For Practice – True or False Questions

1. All corporations are taxed on their earnings at the corporate level and not at the shareholder level.
2. A sole proprietorship files a separate tax return to report earned income.
3. A QSLOB who meets the different industries' safe harbor will have met the administrative scrutiny test.
4. A sole proprietor's earnings are reduced by 100 percent of the self-employment tax when determining earned income.
5. An LLP may be a nonprofit organization.
6. The separate line of business must satisfy a 50-employee requirement, a notice requirement and an administrative scrutiny requirement to be a QSLOB.
7. Each QSLOB must be tested separately for all annual compliance testing.

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[40] Treas. Reg. §1.414(r)-6.

8. A plan must satisfy the nondiscriminatory classification test on an employer-wide basis first before testing on a QSLOB basis.
9. Compensation that may be used for plan purposes, for employees of a C corporation, is Form W-2 compensation.
10. Compensation that may be used for plan purposes, for a partner of a partnership, is Form W-2 compensation.

2.10: Sample Test Questions

1. All of the following statements regarding business entity types are TRUE, EXCEPT:
   A. A sole proprietorship is an unincorporated business owned by only one person.
   B. A partnership is an unincorporated business owned by more than one individual.
   C. An LLP must be treated as a partnership for federal tax purposes.
   D. S corporation income flows to the shareholders and is taxed as if the shareholders were partners.
   E. A C corporation is taxed as a corporation.
2. Based on the following information, determine the net earned income for Partner A:

- Partner A owns 30% of the partnership.
- The partnership has net income, before the profit-sharing contribution, of $450,000.
- The partnership contributes $50,000 to the plan for nonpartner employees.
- Partner A's self-employment tax is $9,000.
- Partner A receives a profit-sharing allocation equal to 5% of compensation.

   A. $105,714
   B. $110,000
   C. $114,286
   D. $115,500
   E. $120,000
3. All of the following statements regarding self-employed individuals are TRUE, EXCEPT:
   A. A qualified plan may cover a self-employed owner as if that individual were an employee.
   B. Compensation for plan purposes is W-2 wages.
   C. Pre-tax elective contributions are included in compensation in determining the maximum deductible employer contribution under IRC §404.
   D. A limited partner will not necessarily derive any earned income from a partnership.
   E. Earned income is not treated as currently available until the end of the taxable year.
4. All of the following safe harbor tests may be used to satisfy the QSLOB administrative scrutiny test, EXCEPT:
   A. Mergers and acquisitions
   B. ADP
   C. Maximum or minimum benefits
   D. Statutory

   E. Industry segment
5. All of the following statements regarding QSLOBs are TRUE, EXCEPT:
   A. They are treated as a single employer for vesting.
   B. They are treated as a separate line of business for coverage.
   C. They are treated as a single employer for eligibility.
   D. They are treated as a separate line of business for nondiscrimination.
   E. They are treated as a separate line of business for IRC §415.

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

2.11: Solutions to True or False Questions

1. False. An S corporation is taxed at the individual shareholder level, not the corporate level.
2. False. The earned income for a sole proprietorship is reported on the individual's tax return, not a separate return for the proprietorship.
3. True.
4. False. The earnings are reduced by ½ of the self-employment tax.
5. False. LLPs must be organized as for-profit entities.
6. True.
7. False. The employer may elect to test on a QSLOB basis for coverage testing under IRC §410(b) (and thereby nondiscrimination testing under IRC §401(a)(4), 401(k) and 401(m)). Top-heavy testing, as well as the application of the IRC §415 limits, among other things, are performed on an employer-wide basis.
8. True.
9. True.
10. False. The partner's compensation for plan purposes will be his or her earned income.

2.12: Solutions to Practice Test Questions

1. The answer is **C**. An LLP may elect to be taxed as a partnership or as a corporation.

2. The answer is **B**.

Partnership income	$450,000
Less contribution to employees	($50,000)
Net income to partners	$400,000
Partner A's portion of income (30%)	× .30
Partner A's income	$120,000
Less ½ of SE Tax for Partner A	($4,500)
Partner A's income	$115,500

Partner A receives a profit-sharing allocation equal to 5 percent of compensation. The algebraic formula is:

$$x = .05(\$115{,}500 - x)$$

$$x = \$5{,}775 - .05x$$

$$1.05x = \$5{,}775$$

$$x = \$5{,}500$$

Hence, Partner A's net earned income = $115,500 - $5,500 = $110,000.

3. The answer is **B**. Plan compensation for a self-employed individual is earned income, not W-2 wages.
4. The answer is **B**. The ADP safe harbor is not a QSLOB safe harbor. There are six QSLOB safe harbors. The additional two are the different industries safe harbor and average benefits safe harbor.
5. The answer is **E**. Testing for IRC §415 is performed as a single employer not on a QSLOB basis.

CHAPTER 3:

CONTROLLED GROUPS AND AFFILIATED SERVICE GROUPS

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3.01: Key Terms

- A-Organization (A-Org)
- Affiliated service group (ASG)
- Attribution
- B-Organization (B-Org)
- Brother-sister controlled group
- Common control test
- Common parent
- Controlled group
- Effective control test
- First service organization (FSO)
- Management group
- Management organization
- Overlapping controlled group
- Parent-subsidiary controlled group
- Professional service corporation
- Recipient organization
- Service organization
- Subsidiaries

3.02: Introduction

A **controlled group** of businesses is one type of related employer group. The other type is an **affiliated service group**. Controlled groups and affiliated service organizations may be comprised of corporations, unincorporated businesses or any combination thereof. This chapter discusses the effect of being a controlled group or affiliated service organization on plan qualification and operation, and defines controlled groups and affiliated groups.

3.03: Controlled Groups

The *controlled group* definition is found in Internal Revenue Code (IRC) §§414(b) and 414(c). IRC §414(b) is limited to controlled groups consisting only of corporations, and refers to IRC §1563 for the appropriate determination of when a controlled group exists. IRC §414(c) applies to all other controlled groups. Because IRC §1563 is written only for corporations, the US Department of Treasury has issued regulations under IRC §414(c) that mirror the IRC §1563 controlled group principles.[1] This chapter explains the controlled group definitions in generic terms applicable to both IRC §414(b) and IRC §414(c) groups. (Any references to a business or organization will include corporations, partnerships, limited liability companies, sole proprietorships, tax-exempt organizations or any other form of business entity.)

3.04: The Effect of Being a Controlled Group

If two or more organizations are part of a controlled group of businesses, the organizations are treated as a single employer when applying the qualified plan requirements specified in IRC §414(b) and (c). These requirements are the general qualification requirements (IRC §401), eligibility and coverage (IRC §410), vesting (IRC §411), the annual addition limitations (IRC §415), the top-heavy rules (IRC §416), the rules for SEPs (IRC §408(k)), and the rules for SIMPLE plans (IRC §408(p)). The paragraphs below provide a brief discussion of these issues.

[1] Treas. Reg. §1.414(c)-1 through §1.414(c)-5.

ELIGIBILITY AND VESTING

If two or more businesses are part of a controlled group, service credited for any member of that group is treated as service with all members for purposes of eligibility and vesting. This is true even if one or more members of the controlled group do not maintain the plan.

COVERAGE TESTING

To determine whether any plan maintained by one or more members of a controlled group satisfies coverage under IRC §410(b), the workforces of all members are taken into account to identify excludable employees and to perform the applicable test. Furthermore, separate plans maintained by controlled group members are eligible for permissive aggregation in applying the coverage testing rules.

NONDISCRIMINATION

If a plan (or permissively aggregated plans) is maintained by one or more members of a controlled group, the controlled group members are treated as a single-employer in applying the nondiscrimination testing rules under IRC §401(a)(4), and, by cross-reference, IRC §401(k) and §401(m). In addition, the identity of highly compensated employees (HCEs), pursuant to IRC §414(q), is determined by treating the controlled group members as a single-employer.

ANNUAL ADDITION LIMITATIONS

Controlled group members are treated as a single-employer for IRC §415 purposes. Thus, annual additions under all defined contribution plans maintained within the group are aggregated to apply the limitations under IRC §415(c), and all benefits accrued under all defined benefit plans maintained within the group are aggregated to apply the limitations under IRC §415(b).

TOP-HEAVY RULES

Companies that are part of a controlled group are treated as a single-employer under the top-heavy rules under IRC §416. This is true for purposes of determining key employees, as well as for calculating the top-heavy ratio. When determining which plans are in the required aggregation group, or whether a plan can be permissively aggregated with the required aggregation group, all of the plans of related group members are taken into account.

COMPENSATION LIMIT

The compensation dollar limit under IRC §401(a)(17) is applied on a single-employer basis. Thus, compensation from all controlled group members is aggregated and limited to a single dollar limit.

ELECTIVE DEFERRAL LIMIT/CATCH-UP CONTRIBUTIONS

The elective deferral limit under IRC §401(a)(30) is applied in the aggregate to plans maintained by members of the controlled group. For example, if an employee participates in two 401(k) plans during the same calendar year, where each plan is maintained by different members of a controlled group, the plans must monitor the employee's aggregate deferrals for the calendar year to determine if IRC §401(a)(30) is exceeded. The same is true for the application of the catch-up limit under IRC §414(v).

Although the IRC §402(g) limit is an individual limit, IRC §401(a)(30) requires that a plan keep elective deferrals by an employee under the limit in order to be a qualified plan. When a controlled group sponsors more than one 401(k) plan, the IRC §401(a)(30) rules apply to the plans in the aggregate. Therefore, if a participant defers to both plans and, in the aggregate, exceeds the IRC §402(g) limit, both plans would be at risk for disqualification.

SEPS/SIMPLES

SEPs under IRC §408(k) and SIMPLE IRA plans under IRC §408(p) must cover the employees of all controlled group members who satisfy the eligibility requirements of IRC §408(k) or IRC §408(p), whichever applies. Also, the 100-employee limit under the SIMPLE IRA rules is applied on a controlled group basis.

DEDUCTIONS

As a general rule, controlled group members are not treated as a single-employer for purposes of applying the deduction limits under IRC §404. However, single-employer treatment results when two or more members of the controlled group participate in the same plan.

3.05: Types of Controlled Group Relationships

A controlled group relationship exists if businesses have a parent-subsidiary relationship or a brother-sister relationship.

PARENT-SUBSIDIARY CONTROLLED GROUP

A **parent-subsidiary controlled group** exists when one business (the **common parent**) owns at least 80 percent of one or more other businesses (the **subsidiaries**).[2] A single parent-subsidiary group may be comprised of multiple subsidiaries owned by a common parent. A single parent-subsidiary group also may consist of multiple tiers of subsidiaries that are at least 80 percent owned by a common parent or one or more subsidiaries in a higher tier within the controlled group structure. This is because the common parent needs to control only one of the organizations within the group, and that organization may control the lower tier subsidiaries.[3]

Illustrative Examples

The following examples illustrate the basic principles of the parent-subsidiary test under the controlled group definition. Note that the companies in these examples happen to be corporations, but the same principles apply regardless of whether the entities are corporations or non-corporate entities (e.g., partnerships, LLCs, sole proprietorships).

EXAMPLE 3-1. Parent and One Subsidiary. Corporation X owns 90 percent of Corporation Y. Neither Corporation X nor Corporation Y owns any other

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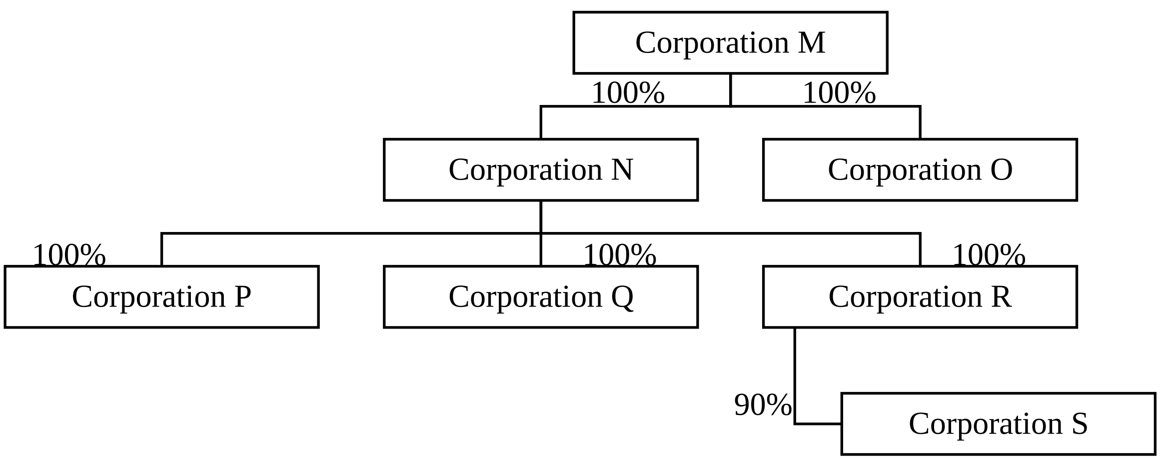
[2] IRC §1563(a)(1) and Treas. Reg. §1.414(c)-2(b).
[3] IRC §1563(a)(1)(B) and Treas. Reg. §1.414(c)-2(b)(1)(ii).

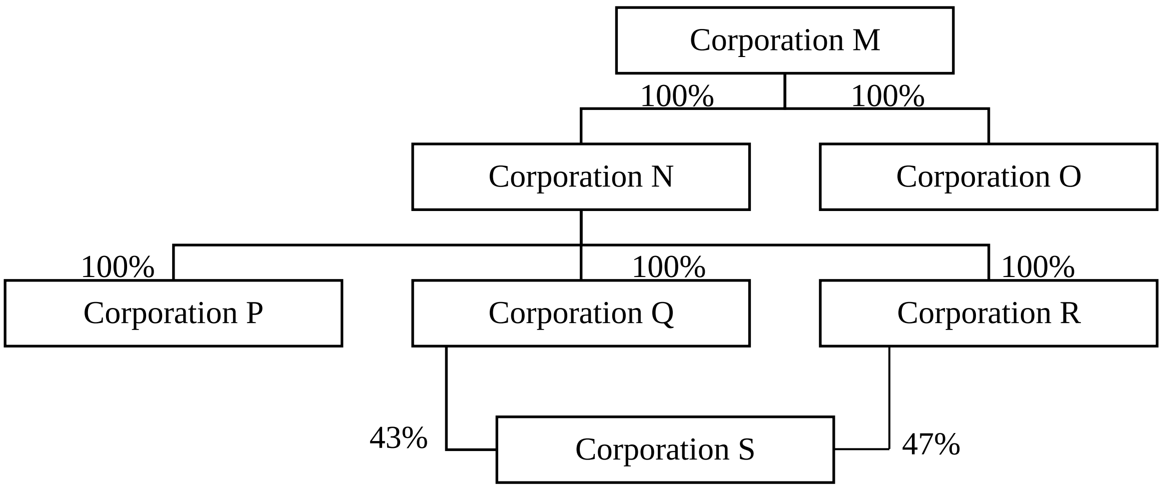
companies. Corporations X and Y constitute a controlled group under the parent-subsidiary test.

EXAMPLE 3-2. Multiple Subsidiaries. Corporation A owns 90 percent of Corporation B, 100 percent of Corporation C and 88 percent of Corporation D. Because Corporation A (the common parent) owns at least 80 percent of all three other companies, the controlled group consists of four companies (A, B, C and D). Note that the result would be the same if one or more of these companies were not corporations, but Corporation A controlled (i.e., owned at least 80 percent of) each one.

EXAMPLE 3-3. Multiple Tiers. Corporation M owns 100 percent of Corporation N and 100 percent of Corporation O. Corporation N owns 100 percent of Corporations P, Q and R. Corporation R owns 90 percent of Corporation S. The controlled group consists of all seven companies (M, N, O, P, Q, R and S) under the parent-subsidiary test. The parent-subsidiary structure actually consists of three tiers of subsidiaries as illustrated in the chart below. The first tier subsidiaries are Corporations N and O because they are controlled by Corporation M (the common parent). The second tier subsidiaries are Corporations P, Q and R, which are controlled by Corporation N (a subsidiary within the first tier, i.e., a higher tier, of subsidiaries). The third tier subsidiary is Corporation S, which is owned by Corporation R, which is within the second tier (i.e., a higher tier) of subsidiaries.



EXAMPLE 3-4. Control by Two or More Entities Within the Structure. Assume, in the prior example, that instead of Corporation R owning 90 percent of Corporation S, Corporation R owns 47 percent of Corporation S, and Corporation Q owns 43 percent of Corporation S—for a total of 90 percent of Corporation S. Corporation S is still part of the controlled group because at least 80 percent of Corporation S is owned by other organizations (i.e., Corporations Q and R) within the controlled group structure.



EXAMPLE 3-5. Some Entities Not Part of Controlled Group. Corporation T owns 100 percent of Corporation U and only 60 percent of Corporation V. The other 40 percent of Corporation V is owned by unrelated persons. Corporations T and U constitute a controlled group under the parent-subsidiary test. However, Corporation V is not part of the parent-subsidiary group because it is not owned at least 80 percent by Corporation T and/or Corporation U. Note, however, that there are some other issues to examine here. For example, see Section 3.04[A]2 below regarding the treatment of Corporation V as part of the controlled group for IRC §415 purposes (when the percentage requirements are reduced). Also, the attribution rules under IRC §1563 might apply and could result in the inclusion of Corporation V in the controlled group. (See Section 3.05[B])

More than 50 Percent Test for IRC §415 Purposes

For purposes of applying the limitations under IRC §415, a parent-subsidiary relationship exists if the parent owns more than 50 percent of the subsidiary.[4] For example, suppose Corporation X owns 60 percent of Corporation Y.

[4] IRC §415(h).

Although Corporation X and Corporation Y are not a parent-subsidiary group, they are treated as one solely for the purpose of applying the IRC §415 limits to the plans they maintain.

Foreign Parent

Beware of two or more US companies that are owned 80 percent or more by a common foreign parent. Although the foreign parent might not have employees that are eligible for the qualified plan, the US companies are, nonetheless, part of a controlled group because of the common foreign parent. The rules under IRC §1563(b), which include an exclusion from the controlled group for certain foreign corporations,[5] are not applicable in determining controlled group status for qualified plan purposes. Usually, the employees of the foreign parent will not impact plan coverage because of the exclusion of nonresident aliens from coverage testing.[6] However, the existence of the foreign parent results in the aggregation of the domestic subsidiaries for purposes of applying the qualification requirements, including the coverage rules under IRC §410(b).

EXAMPLE 3-6. Aggregation of Foreign Companies. HT is a corporation doing business in California. HT is owned 90 percent by a corporation in Japan. The Japanese company also owns 92 percent of DL, a corporation doing business in Colorado. The Japanese company is the common parent of HT and DL, so all three companies constitute a controlled group of businesses. If either HT or DL has a qualified plan, it will need to take into consideration the workforce of the entire controlled group in determining whether the coverage rules under IRC §410(b) are satisfied. However, most, if not all, of the employees working in Japan for the Japanese company are excludable from coverage testing because of the nonresident alien exclusion under IRC §410(b)(3).

A similar issue arises with a foreign subsidiary. Because the foreign subsidiary is a member of the controlled group for qualified plan purposes under IRC §414(b), employees of a foreign subsidiary are employees of a controlled group that includes a domestic parent company.[7]

BROTHER-SISTER CONTROLLED GROUP

A brother-sister controlled group exists if five or fewer common owners satisfy both an 80 percent common control test and a 50 percent effective control test.[8] A common owner must be an individual, a trust or an estate. The businesses must satisfy both tests to constitute a brother-sister relationship.

80 Percent Common Control Test

The 80 percent common control test is satisfied if the combined ownership of the common owners in each business equals or exceeds 80 percent.[9] To be counted in the combined ownership

[5] IRC §1563(b)(2)(C).
[6] IRC §410(b)(3)(C).
[7] PLR 200205050.
[8] IRC §1563(a)(2).
[9] IRC §1563(a)(2)(A).

percentage, the common owner must have at least some ownership (directly or by attribution) in each business being tested.[10]

EXAMPLE 3-7. 80 Percent Common Control Test Satisfied. Individuals K and M are owners in Corporation X. K, M and S are owners in Corporation Y. Ownership is shown in the chart below.

Owner	Corporation X	Corporation Y
K	50%	33.33%
M	50%	33.33%
S	0%	33.33%
Total for Common Owners	**100%**	**66.66%**

S is not a common owner because S does not have any ownership in Corporation X. To apply the 80 percent common control test, only K's and M's interests are considered. K's and M's combined interests in each corporation must equal or exceed 80 percent of the total interests in that corporation in order to satisfy the 80 percent common control test.

EXAMPLE 3-8. 80 Percent Test Not Satisfied. Individual F is the 100 percent owner of Corporation Q. F and three other individuals own Corporation S. F's interest in Corporation S is 70 percent. To apply the 80 percent common control test, only F's interest is considered. This is because F is the only one who has ownership in both corporations, so F is the only common owner for purposes of the common control test. For the 80 percent common control test to be satisfied, F alone must own at least 80 percent of both corporations. The test is not satisfied, because F owns less than 80 percent of Corporation S.

50 Percent Effective Control Test

The 50 percent effective control test is satisfied if the combined identical ownership of the common owners is more than 50 percent.[11] The same five or fewer common owners who were taken into account to satisfy the 80 percent test must be used in the 50 percent effective control test. A common owner's identical ownership means the least percentage owned by that person in the businesses being tested. For example, if a person owns 25 percent of one business and 75 percent of another business, the owner's identical ownership in the two businesses is 25 percent.

[10] *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982).
[11] IRC §1563(a)(2)(B).

EXAMPLE 3-9. 50 Percent Test Satisfied. K and M own Corporations X and Y as shown below. In addition, each owner's least common ownership is shown in the last column. The combined identical ownership is 70 percent, satisfying the 50 percent effective control test.

Owner	**Corporation X**	**Corporation Y**	**Identical Ownership**
K	40%	60%	40%
M	50%	30%	30%
Combined Identical Ownership			**70%**
Total for Common Owners		90%	90%

EXAMPLE 3-10. 50 Percent Test Not Satisfied. Suppose K's ownership interest in Corporation X is 90 percent and K's ownership interest in Corporation Y is 10 percent. M's ownership interest in Corporation X is 10 percent and M's ownership interest in Corporation Y is 90 percent. K's identical ownership is only 10 percent and M's identical ownership is only 10 percent. The combined identical ownership is 20 percent, which does not satisfy the 50 percent effective control test. Therefore, the corporations do not constitute a brother-sister group. This example illustrates how the 50 percent effective control test may fail even though the 80 percent common control test is satisfied.

Owner	**Corporation X**	**Corporation Y**	**Identical Ownership**
K	90%	10%	10%
M	10%	90%	10%
Combined Identical Ownership			20%
Total for Common Owners		100%	100%

EXAMPLE 3-11. Brother-Sister Test Satisfied. Corporations A and E are owned as follows (common owners are shown in bold):

Owner	**Corporation A**	**Corporation E**	**Identical Ownership**
D	40%	30%	30%
M	20%	40%	20%

J	35%	15%	15%
L	5%	0%	—
S	0%	15%	—
Total for Common Owners	95%	85%	65%

To apply the 80 percent common control test, only D, M and J are included because L and S, who do not have ownership in both businesses, are not common owners. D, M and J have a combined ownership of 95 percent in Corporation A. Their combined ownership in Corporation E is 85 percent. Thus, the 80 percent common control test is satisfied. To apply the 50 percent effective control test, the identical ownership percentages for D, M and J are added together. D's identical ownership percentage is 30 percent, M's identical ownership percentage is 20 percent and J's identical ownership percentage is 15 percent. The combined identical ownership is 65 percent, so the 50 percent effective control test is also satisfied. Corporations A and E constitute a brother-sister controlled group.

EXAMPLE 3-12. 80 Percent Test Not Satisfied, but 50 Percent Test Satisfied: No Controlled Group. Suppose, instead of the facts of the prior example, the ownership of Corporations A and E is as follows (common owners are shown in bold):

Owner	Corporation A	Corporation E	Identical Ownership
D	40%	30%	30%
M	25%	40%	25%
J	35%	0%	—
L	0%	15%	—
S	0%	15%	—
Total for Common Owners	65%	70%	55%

To apply the 80 percent common control test, only D and M are included because J, L and S, who do not have ownership in both businesses, are not common owners. The combined ownership in Corporation A for D and M is 65 percent. Their combined ownership in Corporation E is 70 percent. The 80 percent test is not satisfied. The corporations do not constitute a brother-sister relationship, even though D and M could satisfy the 50 percent effective control test. (D's identical ownership percentage is 30 percent, and M's identical ownership percentage is 25 percent, which totals 55 percent.)

EXAMPLE 3-13. 80 Percent Test Satisfied, but 50 Percent Test Not Satisfied: No Controlled Group. Suppose, instead of the facts of the prior example, the ownership of Corporations A and E is as follows (common owners are shown in bold):

Owner	Corporation A	Corporation E	Identical Ownership
D	70%	10%	10%
M	15%	80%	15%
J	5%	0%	—
L	0%	10%	—
S	10%	0%	—
Total for Common Owners	85%	90%	25%

To apply the 80 percent common control test, only D and M are included because J, L and S, who do not have ownership in both businesses, are not common owners. The combined ownership in Corporation A for D and M is 85 percent. Their combined ownership in Corporation E is 90 percent. The 80 percent test is satisfied. To apply the 50 percent effective control test, the identical ownership percentages for D and M are added together. D's identical ownership percentage is 10 percent, and M's identical ownership percentage is 15 percent. The combined identical ownership is 25 percent, failing the 50 percent effective control test. The corporations do not constitute a brother-sister controlled group, even though the 80 percent test is satisfied.

If You're Curious . . .

Special Consideration for Owner of Both a Sole Proprietorship and Stock in a Corporation

Suppose A is a sole proprietor, and the sole proprietorship maintains a qualified plan. A is also a 70 percent shareholder of Corporation X. Because the sole proprietorship is an unincorporated business, it is considered to be interchangeable with A. However, the 50 percent test for purposes of applying the limitations under IRC §415 applies only for a parent-subsidiary group, and not for brother-sister entities. How do we categorize the ownership interests of these two companies?

If we treat the sole proprietorship as owning the 70 percent interest in the corporation, then it is a parent, and Corporation X is the subsidiary. The 50 percent parent-subsidiary test is satisfied, and the sole proprietorship's plan would have to be aggregated with the corporation's plan for IRC §415 purposes.

On the other hand, if we treat A as the owner of the sole proprietorship and the shareholder of Corporation X, the entities are brother-sister companies, and the parent-subsidiary rules of IRC §415 would not apply. This would be the same result if the sole proprietorship were incorporated.

When this fact pattern was posed to the Internal Revenue Service (IRS) in a Q&A session at a conference, the IRS responded informally that the special control test for IRC §415 purposes should not be treated as satisfied by the sole proprietorship and the corporation—in other words, the brother-sister structure outlined above would apply. If you applied this special test to this situation, you would penalize the individual for choosing the unincorporated form of business over the corporate form of business, which is not intended by the statute.[12]

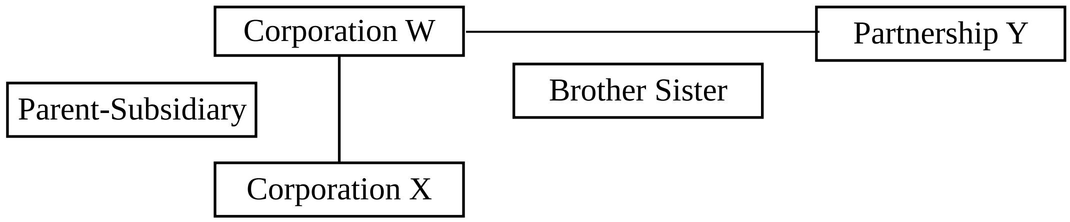
Because this is only an informal position, it would be safer for companies affected by this issue to be incorporated.

COMBINED GROUPS

If a business is the common parent organization in a parent-subsidiary group and is also part of a brother-sister group, the businesses included in both groups constitute one group of businesses.[13] However, if a subsidiary organization in a parent-subsidiary group is also part of a brother-sister group, the businesses in both groups would not be considered one controlled group according to IRC §1563(a)(3).

EXAMPLE 3-14. Combined Groups. Corporation W is the parent company of Corporation X. Corporation W is also part of a brother-sister group with Partnership Y. The controlled group of businesses is made up of Corporations W and X, and Partnership Y. However, if Corporation X, rather than Corporation W, is in a brother-sister group with Partnership Y, the controlled group does not consist of all three businesses. Instead, there are two separate controlled groups with one overlapping member (X): they are WX and XY (assuming no attribution rules result in the three organizations being a single controlled group).

[12] 2001 Annual Conference of the American Society of Pension Professionals & Actuaries, IRS Q&A Session, Q&A-8.
[13] IRC §1563(a)(3), Treas. Reg. §1.414(c)-2(d).



Suppose there are two controlled groups that have a common member. Should that result in the aggregation of the two groups as a single controlled group, even though the ownership in all of the companies taken together could not satisfy the controlled group test? Suppose you have the following facts:

Owner	Corporation A	Corporation B	Corporation C
D	100%	80%	40%
J	0%	20%	40%
Others	0%	0%	20%

Corporations A and B constitute a brother-sister group and Corporations B and C constitute a brother-sister group. However, the three corporations together do not satisfy the brother-sister test because D is the only common owner of all three corporations, and owns less than 80 percent of Corporation C. Corporations A, B and C are not combined into a single controlled group merely because Corporation B is a common member of the two groups. When applying the various qualification requirements (such as coverage and nondiscrimination), Corporation A takes into account Controlled Group AB, Corporation C takes into account Controlled Group BC, but Corporation B must make sure these requirements are satisfied by taking into account Controlled Group AB and by taking into account Controlled Group BC. These controlled groups are an overlapping controlled group, because they have a common member (i.e., they overlap with regard to that member), but they are not one big controlled group because of that overlap.

WHEN THE CONTROLLED GROUP RELATIONSHIP IS DETERMINED

There is no provision in IRC §414(b) that prescribes a single date in a plan year for determining whether a controlled group relationship exists. Rather, Treas. Reg. §1.414(b)-1(a) provides that two or more corporations are members of a controlled group any time such corporations meet the requirements of IRC §1563(a). IRC §1563(b) includes rules for determining component members of a controlled group, where the number of days in which the company is part of the group during a taxable year affects its status as a controlled group member, but Treas. Reg. §1.414(b)-1(a) expressly makes IRC §1563(b) inapplicable to the qualified plan controlled group determination under IRC §414(b). IRC §414(c) and the regulations thereunder take the same approach as the regulations under IRC §414(b). Thus, controlled group status may change when:

- There are changes in ownership;
- Changes in family relationships; or

- The issuance of stock options that might affect the application of the attribution rules under IRC §1563 (see below).

These changes may result in previously unrelated companies becoming part of a controlled group, or related companies falling out of controlled group status. When the controlled group status changes, qualification requirements that are affected by whether the controlled group relationship exists must be examined accordingly. This is usually more straightforward when the change coincides with the first day of a plan year, but controlled group status can change as of any day in a plan year.

3.06: Ownership

EXPLANATION AND APPLICATION

A person's ownership interest depends on the type of business.

If	Then
The organization is a corporation	The ownership interest is stock.
The organization is a partnership	The ownership interest is a capital interest or profits interest in the partnership.
The organization is a limited liability company (LLC)	The ownership interest is usually referred to as a membership interest, but the manner in which the LLC is taxed for federal income tax purposes is usually considered when determining how to classify the ownership.*
The LLC is taxed as a partnership (which is usually the case)	The membership interest should be classified as a profits or capital interest, as with a partnership, based on how those interests are being determined for federal tax purposes under the partnership taxation rules.
The organization is a sole proprietorship	The sole proprietor is treated as a 100 percent owner.
The organization is a trust or estate	The ownership interest is the actuarial interest in that trust or estate.
* In PLR 199905032, the IRS ruled that a partnership would be treated as a corporation for purposes of IRC §401(k)(10) (which allows distribution from 401(k) accounts when a corporation sells a subsidiary or a separate trade or business) because the partnership elected to be taxed as a corporation.	

The required percentages of stock ownership are satisfied either on the basis of voting power or value. When the percentage is determined on the basis of voting power, only classes of stock entitled to vote are considered. When the percentage is determined on the basis of value, all classes of stock are considered. Thus, the applicable controlled group test may need to be run more than once, taking into account a voting power analysis and a value analysis, to determine if a controlled group exists. The applicable percentages, whether based on value or voting power, will not reflect stock that is properly excluded.

Where corporations are involved, the parent-subsidiary test is satisfied if the parent owns at least 80 percent of the voting power or at least 80 percent of the value of the subsidiary's stock. If the parent can satisfy either standard, the 80 percent test is satisfied.

Where corporations are involved in the application of the brother-sister test, the 80 percent test is satisfied if the common owners own at least 80 percent of the combined voting power or at least

80 percent of the combined value of the corporations being tested. Similarly, the 50 percent test is satisfied if the total identical ownership of the common owners, based either on voting power or value, is more than 50 percent. Thus, any of the following four combinations will satisfy the brother-sister test:

1. Common owners own at least 80 percent of combined voting power, and their combined identical ownership (also based on voting power) is more than 50 percent;
2. Common owners own at least 80 percent of combined value, and their combined identical ownership (also based on value) is more than 50 percent;
3. Common owners own at least 80 percent of combined voting power, and their combined identical ownership (based on value) is more than 50 percent; or
4. Common owners own at least 80 percent of combined value, and their combined identical ownership (based on voting power) is more than 50 percent.

ATTRIBUTION OF OWNERSHIP

The purpose of the controlled group rules in the benefits arena is to ensure that when a select group of individuals or companies own other businesses, the employees of those businesses are treated equitably for benefits purposes. In other words, a business owner should not be able to avoid his or her responsibilities to provide nondiscriminatory benefits by employing workers in a separate company that he or she also owns.

The rules ensure an individual is not able to avoid the effect of the controlled group rules by simply putting the company with employees in the name of his or her spouse, parent or child. Therefore, the controlled group rules require a certain amount of attribution of ownership—that is, the treatment of ownership by individuals close to the business owner as if it belonged to the business owner. This way, an owner of one business is deemed to own a second business if that second company is owned by his or her spouse (with certain exceptions).

The IRC has several different attribution rules, three of which apply for employee benefit purposes:

1. IRC §267 attribution is used in the prohibited transaction (PT) rules.
2. IRC §318 attribution is used in determining affiliated service groups and in identifying HCEs and key employees.
3. IRC §1563 attribution is used in determining controlled groups of businesses under IRC §414(b) and (c).

It may be helpful to you if, as you review the information in this attribution section, you diagram the examples using a flowchart style. Visually examining the relationships often helps clarify how the attribution rules are applied. Flow charts also help analyze a given fact situation to see if a controlled group exists.

IRC §1563 Attribution Introduction

The attribution rules of IRC §1563 are written for corporations and refer to stock ownership. Under IRC §414(b), where the controlled group rule is applied to corporations, there is simply a cross-reference to IRC §1563. Under IRC §414(c), where the controlled group rule is applied to a business, whether or not incorporated, the principles of IRC §1563 are applied in determining ownership.[14] The attribution rules are applied to the partnership interests (i.e., capital or profits interests) in the case of a partnership; to the membership interests in the case of a limited liability company (LLC), and to the ownership interest in the case of a sole proprietorship. A sole proprietor is treated as owning 100 percent of his or her business. The IRC §1563 attribution rules will be applied differently when determining a parent-subsidiary group than when determining a brother-sister group.

Family Attribution under IRC §1563

Family attribution involves the attribution of stock ownership among family members. Under IRC §1563, the level of an individual's ownership interest and the type of family relationship may affect how attribution is applied.

Attribution Between Spouses

As a general rule, an individual is attributed any ownership interest held by his or her spouse.[15] If the individual and the spouse are legally separated under a decree of divorce or separate maintenance, there is no attribution.

Individuals are not attributed any ownership in their spouse's business if all the following are met:[16]

- The individual does not have direct ownership in the business;
- The individual is not a director or employee, and does not participate in the management of the business;
- No more than 50 percent of the business' gross income for a taxable year is derived from passive investments (that is, royalties, rents, dividends, interest and annuities); and
- The spouse's ownership interest is not subject to disposition restrictions running in favor of the individual or the minor children of the individual and the spouse. For example, the business owner cannot be required to offer a right of first refusal to his or her spouse or their children before selling the business to a third party.

EXAMPLE 3-15. Exception to Spousal Attribution. R is a doctor and owns 100 percent of a professional corporation engaged in the practice of medicine. L, R's spouse, is an attorney and owns 100 percent of a separate professional corporation engaged in the practice of law. Neither one is involved as a director or employee of the other's corporation, nor in the management of that corporation. R is not attributed L's interest in L's corporation. Similarly, L is not attributed R's interest in R's corporation.

An individual's community property interest in his or her spouse's business ownership would appear to disqualify the individual from the exception described above. This is because, in a community property state, spouses are automatically considered to own half of the property

[14] Treas. Reg. §1.414(c)-4.
[15] IRC §1563(e)(5).
[16] IRC §1563(e)(5).

acquired during the marriage, except under certain limited circumstances. The individual would be able to qualify for the exception if the community property interest is relinquished or the spouse's business ownership is treated as separate property under the applicable community property law. There are eight states that apply community property interests. They are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.

Attribution Between Parents and Minor Children

If an individual has a minor child, which is defined as a child under the age of 21, any interest held by that minor child is treated as owned by the individual. Similarly, any interest held by the individual is attributed to such minor child.[17] A legally adopted child is treated as the individual's child for attribution purposes.[18]

EXAMPLE 3-16. Attribution Between Parents and Minor Children. A married couple owns 100 percent of two businesses—Corporation X and Corporation Y. The couple has two minor children, ages 16 and 19. The couple gifts 100 percent of the stock of Corporation Y to the two children. After the gift, Corporation X is owned 100 percent by the couple and Corporation Y is owned 100 percent by the children. Because the children are minors, the couple is still treated as owning 100 percent of Corporation Y through attribution. Thus, Corporations X and Y continue to constitute a controlled group of corporations under IRC §414(b).

Limited Attribution to and from Adult Children (Age 21 or Older)

If an individual's child is age 21 or older, only a limited attribution rule applies. Attribution applies to the parent only if the parent owns more than 50 percent of a business (by direct ownership or by other attribution), and only the ownership held by the child in that business is attributed to the parent. Similarly, if the child owns more than 50 percent of a business, any ownership held by the child's parent in that business is attributed to the child.

EXAMPLE 3-17. Parent Owns More than 50 Percent. Parent J owns 60 percent of Corporation T. J's two children, both over age 21, own the other 40 percent (20 percent each). J is attributed the children's stock because J owns more than 50 percent of the corporation. However, J's children are not attributed J's stock because neither owns more than 50 percent of the corporation.

[17] IRC §1563(e)(6)(A).
[18] IRC §1563(e)(6)(C).

Owner	Corporation T – Before Attribution	Corporation T – After Attribution
Parent J	60%	100%
Child M over age 21	20%	20%
Child N over age 21	20%	20%

Are Corporations S and T part of a brother-sister controlled group? Because parent J is not attributed M's stock in Corporation S, J is not a common owner of Corporations T and S. Therefore, these corporations would not be part of a controlled group, even though J's children own part of both companies because J owns 60 percent of Corporation T and nothing of Corporation S. As shown in Example 3-17, J's children are not attributed J's 60 percent in Corporation T, so even though the children are common owners of Corporations T and S, they do not own enough of the two companies to satisfy the brother-sister test.

EXAMPLE 3-18. Child Owns Stock in a Separate Company. Assume from the prior example that M, one of J's children, owns 85 percent of the stock of Corporation S. The other 15 percent is owned by an unrelated individual. J is not attributed the Corporation S stock owned by M because attribution under this rule only applies to the stock in Corporation T (i.e., the corporation of which J owns more than 50 percent).

Owner	Corporation T – Before Attribution	Corporation T – After Attribution	Corporation S	Identical Ownership
Parent J	60%	100%		0%
Child M over age 21	20%	20%	85%	20%
Child N over age 21	20%	20%		0%
Other			15%	0%
Combined Identical Ownership				20%

Are Corporations S and T part of a brother-sister controlled group? Because parent J is not attributed M's stock in Corporation S, J is not a common owner of Corporations T and S. Therefore, these corporations would not be part of a controlled group, even though J's children own part of both companies because J owns 60 percent of Corporation T and nothing of Corporation S. As shown in Example 3-17, J's children are not attributed J's 60 percent in Corporation T, so even though the children are common owners of Corporations T and S, they do not own enough of the two companies to satisfy the brother-sister test.

The above example illustrates the limited scope of attribution with respect to adult children. Family members may own controlling interests in two or more companies, but because of the way the ownership is divided, this attribution rule is avoided. As a result, the companies may not fall within the controlled group definition. For example, suppose a husband and wife own 100 percent of one corporation and their three children own one-third interests in another corporation. If the children are age 21 or older, none of the interests in their corporation would be attributed to their parents, and none of the interests in the parents' corporation would be attributed to the children. The corporations would not constitute a controlled group.

Even though family-owned businesses might not constitute a controlled group because attribution rules fail to attribute ownership interest between the family members, the businesses may, nonetheless, be related for qualified plan purposes under the affiliated service group definition in IRC §414(m).

EXAMPLE 3-19. Spousal Attribution Gets Parent Above 50 Percent, Which Leads to Attribution from Adult Children. B owns 30 percent of Corporation Z. B's spouse, J, owns 25 percent of Corporation Z. B's children from a prior marriage, L and M, are 21 or older and own the remaining 45 percent. Normally, B would not be attributed the stock owned by L and M because B does not own more than 50 percent of Corporation Z. However, after attribution of J's stock to B (because of the spousal attribution rule), B owns 55 percent and B is attributed the stock owned by B's adult children. Thus, after the application of all of the attribution rules, B is a 100 percent owner of Corporation Z. If B is also an 80 percent or more owner of another company, that company would be part of a controlled group with Corporation Z.

Owner	Corporation Z – Before Attribution	Corporation Z – After Attribution
Parent B	30%	100%
J Spouse of B	25%	25%
Child M over age 21	23%	20%
Child N over age 21	22%	20%

Attribution Between Grandparents and Grandchildren

The attribution rule for grandparents and grandchildren works similarly to the rule for children who are age 21 or older, but there is no age requirement for the grandchildren in this rule. If an individual owns more than 50 percent of a business, any interest in that business owned by that individual's grandchildren or grandparents is attributed to the individual.

EXAMPLE 3-20. Attribution from Grandparent to Grandchild. Grandparent P owns 60 percent of Corporation D. P's grandchild, R, owns the other 40 percent. P is attributed R's stock because P owns more than 50 percent of the corporation and R is P's grandchild. However, R is not attributed P's stock because R does not own more than 50 percent of Corporation D.

Owner	Corporation D – Before Attribution	Corporation D – After Attribution
Grandparent P	60%	100%
Grandchild R	40%	40%

EXAMPLE 3-21. Attribution Determined Separately for Different Controlled Groups. Assume, in the prior example, that R owns 75 percent of the stock of Corporation F. The other 25 percent is owned by an unrelated individual. P is not attributed the Corporation F stock owned by R because attribution under this rule only applies to the stock in Corporation D (i.e., the corporation of which P owns more than 50 percent).

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.[19] This is known as the prohibition on double attribution.

EXAMPLE 3-22. No Double Attribution. M owns 60 percent of Corporation B. M is married to L, who does not have any direct ownership in Corporation B. L has a daughter, P, age 16. P is not M's daughter, and M has not adopted P. M's 60 percent ownership interest is attributed to L, but it is not attributed from L to L's minor daughter. Although L is treated as owning 60 percent by attribution, that interest is not treated as owned by L for purposes of attributing that interest to P.

The purpose of the no double attribution rule is to prevent multiple tiers of family attribution. That way, an individual's indirect ownership through attribution is not then treated as direct ownership

[19] IRC §1563(f)(2)(B).

to be applied in yet another round of family attribution. However, it does not affect multiple attributions when an owner is related to two or more family members, as described below.

EXAMPLE 3-23. Attribution to Spouse and Child. R owns 40 percent of Corporation W. R's daughter, T, owns the other 60 percent. T is 28. R's spouse, M, has no direct ownership. R's stock is attributed to M under spousal attribution (assuming the spousal exception is not applicable), and R's stock is also attributed to T under the adult children attribution rule because T owns at least 50 percent of Corporation W. This is not considered double attribution because the stock is directly attributed from R to M and from R to T. However, because of the no double attribution rule, if T is married, T's spouse, K, is not attributed the stock that is attributed from R to T. T's spouse would be attributed only the 60 percent interest directly owned by T.

Owner	Corporation W – Before Attribution	Corporation W – After Attribution
Parent R	40%	40%
Daughter T over age 21	60%	40%
M Spouse of R	0%	40%
K Spouse of T	0%	60%

No Attribution Between Siblings

There is no attribution under IRC §1563 between siblings.

EXAMPLE 3-24. No Attribution Among Siblings. S and P are siblings. S owns 40 percent of Company X. P does not have any direct ownership in Company X. P is not attributed S's ownership interest in Company X.

Suppose that C is S and P's mother. C directly owns 55 percent of Company X. S's interest in Company X is attributed to C (even if S is over age 21) because C owns more than 50 percent of Company X. However, the stock attributed from S to C is not again attributed to P, who is C's child, even if P is under age 21, because of the no double attribution rule described above. However, the stock C owns directly is attributed to P if P is under age 21.

Summary of Family Attribution under IRC §1563

- Attribution between spouses (unless exception applies);
- Attribution from parent to minor child (under age 21);
- Attribution from minor child to parent;

- Attribution from adult child (21 or older) to parent only if parent owns (directly or by other attribution) more than 50 percent of the company, and only the child's ownership in that company is attributed to the parent;
- Attribution from parent to adult child only if adult child owns (directly or by other attribution) more than 50 percent of the company, and only the parent's ownership in that company is attributed to the adult child;
- Attribution from grandchild (regardless of age) to grandparent only if grandparent owns (directly or by other attribution) more than 50 percent of the company, and only the grandchild's ownership in that company is attributed to the grandparent;
- Attribution from grandparent to grandchild (regardless of age) only if grandchild owns (directly or by other attribution) more than 50 percent of the company, and only the grandparent's ownership in that company is attributed to the adult grandchild; and
- No attribution between siblings.

3.07: Affiliated Service Groups

An **affiliated service group** (ASG) is another type of group of related employers. The ASG designation refers to two or more organizations that have a service relationship, and, in some cases, an ownership relationship, as described in IRC §414(m). The ASG rules were enacted by Congress as a reaction to the avoidance of the controlled group rules by certain professional organizations. For example, consider a situation in which two physicians practice together. Each physician owns all of his or her own medical corporation, which employs only him or her. Each physician also owns 50 percent of a partnership, which employs all of the other employees of the practice. Because neither physician has ownership in the other's medical corporation, and because neither physician controls at least 80 percent of the partnership, there is no controlled group. As a result, each doctor can have a plan in the medical corporation that covers no employees because the medical corporation does not need to be aggregated with the partnership for coverage rules.

This structure was challenged in Tax Court in the *Garland*[20] and *Kiddie*[21] cases, and the Court agreed that it effectively avoided application of the controlled group rules. As a result, Congress added IRC §§414(m), 414(n) and 414(o) to eliminate this means of bypassing coverage obligations.

An ASG can fall into any one of three categories: A-Org groups, B-Org groups and management groups which are explained later in this chapter.

3.08: Effect of Being an ASG

If two or more organizations are part of an ASG, the organizations are treated as a single-employer when applying certain employee benefit requirements.[22] What are these requirements?

[20] *Lloyd M. Garland, M.D., F.A.C.S. v. Commissioner*, 73 T.C. 5 (1980).
[21] *Thomas Kiddie, M.D., Inc. v. Commissioner*, 69 T.C. 1055 (1978).
[22] IRC §414(m)(3).

ELIGIBILITY AND VESTING

An employee's service with all ASG members is aggregated to determine if eligibility and vesting service requirements are satisfied under any plan maintained by one or more ASG members.

COVERAGE TESTING

To determine whether any plan maintained by one or more members of an ASG satisfies coverage under IRC §410(b), the workforces of all members are taken into account to identify excludable employees and to perform the applicable test. Furthermore, separate plans maintained by ASG members are eligible for permissive aggregation in applying the coverage testing rules.

NONDISCRIMINATION

If a plan (or permissively aggregated plans) is maintained by one or more members of an ASG, the ASG members are treated as a single-employer in applying the nondiscrimination testing rules under IRC §401(a)(4) and, by cross-reference, IRC §§401(k) and §401(m). In addition, the identity of HCEs, pursuant to IRC §414(q), is determined by treating the ASG members as a single-employer.

ANNUAL ADDITION LIMITATIONS

ASG members are treated as a single-employer. Thus, annual additions under all defined contribution plans maintained within the group are aggregated to apply the limitations under IRC §415(c), and all benefits accrued under all defined benefit plans maintained within the group are aggregated to apply the limitations under IRC §415(b).

TOP-HEAVY RULES

The top-heavy rules under IRC §416 are applied on a single-employer basis. Thus, the top-heavy determination (including the determination of the required aggregation group for testing purposes and the identity of key employees) as well as the application of the top-heavy minimum benefit rules are performed by taking into account all plans maintained by any of the ASG members.

COMPENSATION LIMIT

The compensation dollar limit under IRC §401(a)(17) is applied on a single-employer basis. Thus, compensation from all ASG members is aggregated and limited to a single dollar limit.

ELECTIVE DEFERRAL LIMIT/CATCH-UP CONTRIBUTIONS

The elective deferral limit under IRC §401(a)(30) is applied in the aggregate to plans maintained by members of the affiliated group. For example, if an employee participates in two 401(k) plans during the same calendar year, where each plan is maintained by different members of an affiliated service group, the plans must monitor the employee's aggregate deferrals for the calendar year to determine if IRC §401(a)(30) is exceeded. The same is true for application of the catch-up limit under IRC §414(v).

SEPS/SIMPLES

SEPs under IRC §408(k) and SIMPLE IRA plans under IRC §408(p) must cover the employees of all ASG members who satisfy the eligibility requirements of IRC §408(k) or IRC §408(p), whichever applies. Also, the 100-employee limit under the SIMPLE IRA rules is applied on an ASG basis.

3.09: A-Org Groups

An A-Org group consists of an organization designated as a **first service organization** (FSO) (see Section 3.08[B] below) and at least one A-Organization, also called an A-Org. The term A-Organization is a reference to the last letter in IRC §414(m)(2)(A), which is the IRC section that describes the A-Org group.

DEFINITION OF A-ORGANIZATION

To be part of an A-Org group, the A-Organization must satisfy the following requirements:

- The A-Organization must have ownership interest in the FSO; and
- The A-Organization must regularly perform services for the FSO, or must be regularly associated with the FSO in performing services for third persons (e.g., patients, clients).

FIRST SERVICE ORGANIZATION

The first service organization (FSO) may be any type of entity, such as a corporation, partnership or limited liability company. However, if it is a corporation, the entity must be a professional service corporation to be an FSO with respect to an A-Organization.

A professional service corporation is a corporation organized for the principal purpose of providing professional services. Professional services are those services performed by accountants, actuaries, architects, attorneys, chiropodists, chiropractors, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists and veterinarians.[23] At least one shareholder of the corporation must be licensed or otherwise legally authorized to render the professional services. The governing state statute will not necessarily designate the corporation as a professional service corporation or similar designation. What is important is that the corporation is formed for the purpose of providing at least one of the types of professional services listed above. In other words, the IRS apparently will characterize a corporation as a professional service corporation for purposes of the A-Org test if it satisfies the definition in this paragraph, even if the corporation is not formally recognized as a professional service corporation under applicable state statutes.

SERVICE ORGANIZATION

Both the FSO and the A-Organization must be service organizations. An organization is a service organization if capital is not a material income-producing factor. As a general rule, capital is a

[23] Prop. Treas. Reg. §1.414(m)-1(c).

material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business (e.g., substantial investment in inventories, plant, machinery or other equipment).[24]

If the gross income of a business consists principally of fees, commissions or other compensation for personal services performed by an individual, the business is a service organization.[25] Furthermore, organizations engaged in the following fields are service organizations regardless of whether capital is a material income-producing factor:

- Health
- Law
- Engineering
- Architecture
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Insurance[26]

An organization engaged in the manufacture or sale of equipment or supplies used in the above fields (e.g., a software company that sells accounting software) or that performs research or publishing in the above fields, is not a service organization merely because of such activities.

The regulations specifically exclude banks and other financial institutions from being service organizations.[27]

OWNERSHIP INTEREST IN FSO

To be an A-Org, the A-Organization must have an ownership interest in the FSO. The A-Organization's ownership interest is stock if the FSO is a corporation, or a partnership interest if the FSO is a partnership. Any degree of ownership satisfies this requirement. In addition, the attribution rules of IRC §318 apply in determining ownership.[28] The IRC §318 attribution rules are discussed below in Section 3.13[A].

REGULARLY PERFORMING SERVICES

To be an ASG, the A-Organization must regularly perform services for the FSO or be regularly associated with the FSO in the performance of services for third parties. Whether this requirement is met is determined under all relevant facts and circumstances.[29] One relevant factor is the amount of earned income the A-Organization derives from the FSO or from performing services for third parties in its association with the FSO.

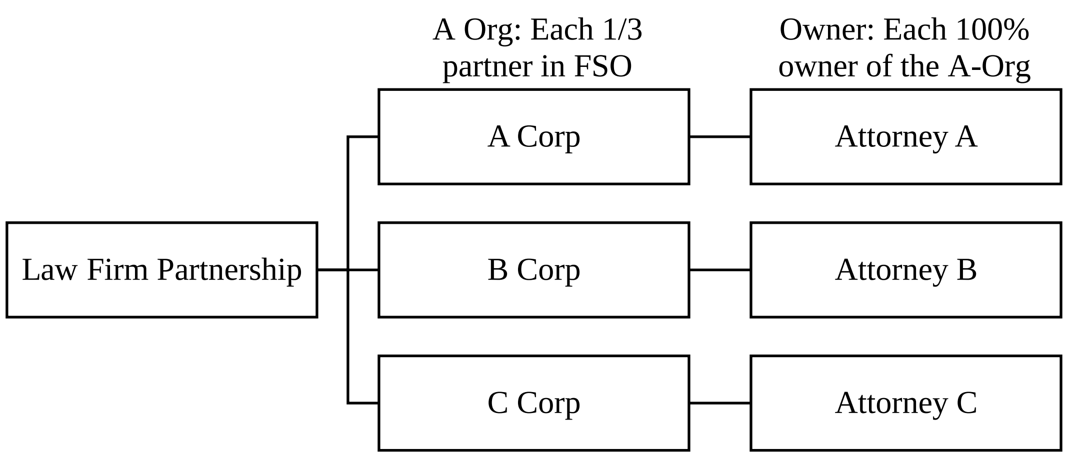
[24] Prop. Treas. Reg. §1.414(m)-2(f)(1).
[25] Prop. Treas. Reg. §1.401(m)-1(f)(1).
[26] Prop. Treas. Reg. §1.414(m)-2(f)(2).
[27] Prop. Treas. Reg. §1.401(m)-1(f)(1).
[28] IRC §414(m)(6)(B).
[29] Prop. Treas. Reg. §1.414(m)-2(b)(2).

The A-Organization cannot avoid the affiliated service designation merely by billing for its services separately from those of the FSO. If those fees are derived from performing services for the FSO or from providing services for third parties (e.g., patients) in association with the FSO, those billings are still taken into account to determine whether such services are performed on a regular basis.

ILLUSTRATIONS OF A-ORG GROUPS

The following examples illustrate A-Org groups.

EXAMPLE 3-25. Partnership of Professional Corporations. A law firm is structured as a partnership. There are three partners. Each partner is separately incorporated as a professional corporation. Each corporation has a one-third partnership interest in the law firm. The sole employee and sole shareholder of each professional corporation is an attorney who would otherwise be an individual partner of the law firm if he or she were not incorporated. All billings for legal services are done by the law firm and partnership income is distributed among the corporate partners according to the partnership agreement. The law firm is the FSO and each of the three corporate partners is an A-Organization with respect to that FSO. The four organizations constitute an affiliated service group. This is the classic example of an A-Org affiliated service group.



EXAMPLE 3-26. Separate Billing by Corporate Partners. Assume the same scenario as in Example 3-25, except each corporate partner bills separately for certain services. Each corporation is still an A-Organization with respect to the FSO because it derives its income from its association with the law firm in providing legal services.

EXAMPLE 3-27. Real Estate Brokerage Firm. A real estate brokerage agency is organized as a partnership. A broker is separately incorporated. The broker's corporation is a 5 percent partner in the agency. The agency is a service organization because its income is derived principally from fees and commissions for personal services. The agency may be an FSO, even though it is not engaged in professional services, because it is not a corporation. The broker's corporation is regularly associated with the agency in performing services for third parties. The broker's corporation is an A-Organization with respect to the agency. The organizations constitute an affiliated service group.

Suppose the real estate agency is a corporation. Then the A-Org test would not be satisfied because the real estate agency would not be an FSO. This is because the FSO under the A-Org test must be a professional service corporation providing professional services if it is a corporation. Real estate brokerage services are not included in the regulatory definition of professional services.

EXAMPLE 3-28. Sales Between Two Retail Businesses. Corporation Y is engaged in a retail business. Corporation Y owns a 40 percent interest in Corporation Z, which manufactures goods sold by Corporation Y. Corporation Z regularly sells goods to Corporation Y. Neither Corporation Y nor Corporation Z is a service organization, so the affiliated service group rules are not applicable. Corporations Y and Z will not constitute a related group unless they fall under the controlled group of businesses definition under IRC §414(b) or (c).

3.10: B-Org Groups

A B-Org group consists of an FSO and at least one B-Organization. The term **B-Organization** is a reference to the last letter in IRC §414(m)(2)(B), which is the IRC section that describes the B-Org group.

DEFINITION OF B-ORGANIZATION

The B-Organization does not have to be a service organization, as defined above for the A-Org group. To be part of a B-Org group, the B-Organization must satisfy all of the following:

1. Derive a significant portion of its business from the performance of services for the FSO, or for the A-Organization(s) related to that FSO, or any combination of such organizations. Notice that the indirect service test under the A-Organization definition (i.e., regular association in providing service for third persons) is not applicable here. The services performed by the B-Organization must be for the FSO and/or A-Organization(s).

2. Perform services for the FSO or A-Organization that are the type historically performed by employees.

3. Owned at least 10 percent by persons who are HCEs of the FSO or A-Organization. The attribution rules under IRC §318 apply to determine ownership.[30]

FSO

The FSO must be a service organization, as described for A-Org groups. If the FSO in a B-Organization relationship is a corporation, it does not need to be a professional service corporation like it does for A-Org groups.

SIGNIFICANT PORTION OF BUSINESS

To determine whether the B-Organization derives a significant portion of its business from performing services for the FSO or A-Organization, the regulations outline two safe harbors:

I. One that deems the test to be automatically satisfied, and

II. The other that deems the test to be automatically not satisfied.[31]

The safe harbors are based on receipts. If neither safe harbor applies, the determination is based on facts and circumstances.

Service Receipts Safe Harbor Test

The B-Organization's services are not considered significant if its service receipts percentage is less than 5 percent. The service receipts percentage is the ratio of the gross receipts derived from services the B-Organization performs for the FSO and/or the A-Organization(s) to the total gross receipts derived by the B-Organization from all services it performed.

Total Receipts Safe Harbor Test

The B-Organization's services are considered significant if its total receipts percentage is 10 percent or more. The total receipts percentage is the ratio of the gross receipts derived from *services* the B-Organization performs for the FSO and/ or the A-Organization(s) to the total gross receipts of the B-Organization (*whether or not service-related*).

HISTORICALLY PERFORMED BY EMPLOYEES

The services performed by the B-Organization must be historically performed by employees of the FSO or A-Organization. This assumes that it was not unusual for the services to be performed by employees in the service field of the FSOs or A-Organizations on December 13, 1980, when the regulation was first effective.[32]

ILLUSTRATIONS OF B-ORG GROUPS

The following examples illustrate B-Org groups.

[30] IRC §414(m)(6)(B).
[31] Prop. Treas. Reg. §1.414(m)-2(c)(2).
[32] Prop. Treas. Reg. §1.414(m)-2(c)(3).

EXAMPLE 3-29. Owner of FSO Also Owns Company that Provides Services to the FSO. N, a CPA, is a 15 percent shareholder in an accounting firm. N also has a 20 percent interest in Corporation X, which provides word processing and other clerical and secretarial services. The accounting firm engages the services of Corporation X during heavy workload periods. Corporation X derives at least 10 percent of its gross receipts from this relationship. The accounting firm and Corporation X constitute an affiliated service group. The accounting firm is the FSO. Corporation X is a B-Organization with respect to the FSO because it performs services that are historically performed by employees, it meets the total receipts safe harbor test, and N, who is an HCE of the accounting firm, owns at least 10 percent of Corporation X.

Company Services	Accounting Firm (FSO) – Accounting services for clients	Corporation X (B-Organization) – Provides clerical and secretarial services to firms, including Accounting Firm
Percentage owned by N	15%	20%

EXAMPLE 3-30. Potential FSO is Not a Service Organization. Corporation Y is in the business of developing and reselling land. J is a 20 percent shareholder of Corporation Y. J also owns 40 percent of Corporation Z, a construction company. Corporation Y regularly engages Corporation Z's services in the development of land owned by Corporation Y. Corporation Z derives at least 10 percent of its gross receipts from this relationship. The affiliated service group rules are not applicable here because Corporation Y, the potential FSO, is not a service organization.

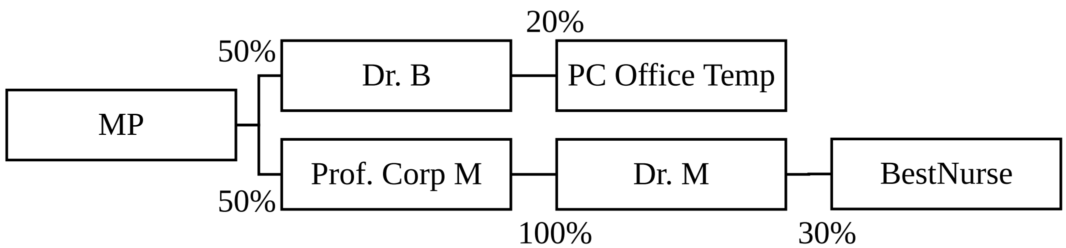
3.11: Multiple A-Organizations or B-Organizations and Multiple Related Employers

The ASG is determined with reference to the FSO. All A-Organizations and B-Organizations that are identified with the same FSO constitute one ASG.[33]

EXAMPLE 3-31. Multiple Organizations. MP is a medical practice with two equal shareholders, Dr. B and Professional Corp. M. Professional Corp. M is, in turn, owned 100 percent by Dr. M. Dr. B owns a 20 percent interest in PC OfficeTemps, which provides secretarial services to professional practices,

[33] Prop. Treas. Reg. §1.414(m)-2(g)(2).

including MP. PC OfficeTemps derives 15 percent of its gross receipts from the services it performs for MP. Dr. M owns a 30 percent interest in BestNurse, which provides nursing services to the medical practices. BestNurse derives 20 percent of its gross receipts from the services it performs for MP. The ownership relationships are exhibited as follows:



Professional Corp. M is an A-Org. Professional Corp. M is a 50 percent shareholder of MP. Through that corporation, Dr. M provides medical services for MP. Therefore, the A-Org definition has been satisfied.

PC OfficeTemps is a B-Org. PC OfficeTemps is a B-Organization with respect to MP because it performs services historically performed by employees (secretarial services), it meets the total receipts safe harbor, and Dr. B, an HCE of MP (because of his 50 percent ownership in MP), owns at least 10 percent of its stock.

BestNurse is a B-Org. BestNurse is also a B-Organization with respect to MP because it performs services historically performed by employees (nursing services), it meets the total receipts safe harbor, and Dr. M, an HCE of MP (because of his 50 percent ownership through Professional Corp. M), owns at least 10 percent of its stock.

ASG consists of four members. Since MP is a common FSO with respect to Professional Corp. M as the A-Organization, and PC OfficeTemps and BestNurse as the B-Organizations, the ASG consists of all four corporations.[34]

[34] Prop. Treas. Reg. §1.414(m)-2(g)(3), Example (2).

FSO	**MP** Owned 50% by Dr. B, 50% by Professional Corp. M	
A-Orgs	**Professional Corp. M** Owned 100% by Dr. M	
B-Orgs	**PC Office Temps** Owned 20% by Dr. B (an HCE of FSO) Provides services to FSO 15% of gross receipts from MP	**BestNurse** Owned 30% by Dr. M (an HCE of A-Org) Provides services to FSO 20% of gross receipts from MP

An organization is part of two separate ASGs if it is an A-Organization or B-Organization for two different FSOs.[35]

EXAMPLE 3-32. Two Different FSOs. Suppose, in the prior example, that PC OfficeTemps also provides secretarial services to an unrelated dental practice. An HCE of that dental practice owns at least 10 percent of PC OfficeTemps. PC OfficeTemps derives at least 10 percent of its gross receipts from performing secretarial services for the dental practice. The dental practice and PC OfficeTemps constitute a separate ASG, under which the dental practice is the FSO and PC OfficeTemps is the B-Organization. PC OfficeTemps is part of two separate ASGs.[36]

3.12: Management Groups

A **management group** consists of a **recipient organization** and a **management organization**. To be an **affiliated service group**, the management organization's principal business must be the performance of management functions, on a regular and continuing basis, for the recipient organization.[37]

The management group test focuses solely on the type and degree of services performed. There is no ownership requirement between the management organization and the recipient organization. Also, the HCEs of the recipient organization need not have any ownership interest in the management organization.

MANAGEMENT FUNCTIONS

The law does not provide a definition of management functions. The term should be interpreted under common business practices. Activities that involve daily business operations, hiring or firing

[35] Prop. Treas. Reg. §1.414(m)-2(g)(1).
[36] Prop. Treas. Reg. §1.414(m)-2(g)(3), Example (1), for a similar example.
[37] IRC §414(m)(5).

personnel, business planning, setting employee compensation and supervisory roles would be examples of management functions.

PRINCIPAL BUSINESS MUST BE PERFORMANCE OF MANAGEMENT FUNCTIONS

The law does not provide any objective test in determining whether the management organization's principal business is performing management functions for the recipient organization. In normal usage, principal means the main function, suggesting a majority (more than 50 percent) of the organization's business. Looking at gross receipts for management functions as compared to total receipts would be a reasonable approach.

ORGANIZATIONS RELATED TO RECIPIENT ORGANIZATION

If there are organizations related to the recipient organization, the affiliated service group includes any such related organizations for which the management organization provides management functions.[38] Whether an organization is related to the recipient organization is determined under IRC §144(a)(3) (which refers back to IRC §§267 [which, as we noted earlier, is used for attribution for PT purposes] and 1563(a) [which we have seen used for controlled group purposes in this chapter], as well as §707(b) [a totally different section generally not used for employee benefit plan purposes]). The management functions performed for the recipient organizations and all of its related organizations are aggregated to determine whether the management organization's principal business is the performance of such functions.

ORGANIZATIONS RELATED TO MANAGEMENT ORGANIZATION

The law does not include organizations related to the management organization in the ASG.

ILLUSTRATIONS OF MANAGEMENT GROUPS

The following examples illustrate management groups.

EXAMPLE 3-33. Services Provided for Only One Organization. T is a former executive with Corporation G. T has formed a management consulting firm, Corporation L. T's sole client is T's former employer, Corporation G. T continues to provide management services for Corporation G through T's wholly-owned Corporation, L. Corporations G and L constitute an ASG. This is true even though there is no common ownership between Corporation G and Corporation L.

EXAMPLE 3-34. Services Divided Among Four Unrelated Companies. Assume, in EXAMPLE 3-33, that Corporation L also performs management

[38] IRC §414(m)(5)(B).

services for three corporations other than Corporation G. None of these corporations is related to Corporation G under IRC §144(a)(3). Corporation L does not derive its principal business under any one of these relationships. Corporation L is not part of an ASG with Corporation G or with any of the other three corporations.

IMPACT OF ASG RELATIONSHIP IS PRIMARILY ON THE MANAGEMENT ORGANIZATION

Usually, when a management group relationship exists, it is the management organization that is adversely affected. The typical management organization employs solely or primarily HCEs. If the organization establishes a separate plan to cover its employees, the coverage requirements under IRC §410(b) usually are not satisfied because the recipient organization typically employs most, if not all, of the nonhighly compensated employees (NHCEs) of the affiliated service group. As a result, the management organization either has to join in the same plan as the recipient organization, or has to maintain a plan that can be permissively aggregated with the recipient organization's plan to satisfy coverage requirements under IRC §410(b) and nondiscrimination testing requirements under IRC §401(a)(4).

EXAMPLE 3-35. Application of ASG Rules. In Example 3-33, suppose T is the sole employee of a wholly owned corporation, Corporation L. Further assume that Corporation G, the recipient organization in this management ASG, has 90 employees, 85 of whom are NHCEs. Corporation G maintains a profit-sharing plan for its employees and annually contributes between 3 percent to 5 percent of compensation. Corporation L maintains a profit-sharing plan under which it makes discretionary contributions that, in many years, reach the maximum deductible limit under IRC §404 (i.e., 25 percent of T's compensation), or the IRC §415 limit, if less.

Corporation L's plan will not satisfy coverage on its own, so it must be aggregated with Corporation G's plan to pass coverage. That means the plans, when examined together, will have to be nondiscriminatory under IRC §401(a)(4). Because T's employer contribution allocation rate (which might be as high as 25 percent) is substantially higher than the contribution allocation rate for the employees in Corporation G's plan (3 percent to 5 percent), the cross-testing rules of Treas. Reg. §1.401(a) (4)-8 will have to be employed to satisfy the nondiscrimination test (and might not be satisfied if T is younger than many of the NHCEs). If cross-testing needs to be performed, Treas. Reg. §1.401(a)(4)-8(b) requires the NHCEs to have a minimum contribution level (known as the gateway requirement), which will be 5 percent of compensation if T's allocation rate is 15 percent or more.

The permissive aggregation option discussed here is available only if Corporation L's plan and Corporation G's plan have the same plan year.[39]

The net result is that, if the Corporation L plan cannot meet the nondiscrimination requirements, it must be modified to reduce T's allocation. Alternatively, Corporation G may agree to increase its rate of contribution for its employees, but that is relatively unlikely if the sole purpose of the increase is to enable T to get more benefits. Therefore, the plan of the management organization is the one that is adversely affected by the operation of these rules.

EXAMPLE 3-36. Aggregation of Plans in ASG. Suppose, in the prior example, that Corporation G's plan is a 401(k) type of profit-sharing plan, but the employer does not make profit-sharing contributions to that plan. The only contributions made to Corporation G's plan are 401(k) and matching contributions. Corporation L's plan may not be aggregated with Corporation G's plan to pass coverage and nondiscrimination testing because an employer's nonelective contribution to a profit-sharing plan may not be aggregated with (and is, in fact, mandatorily disaggregated from) a 401(k) arrangement (i.e., the elective deferrals under Corporation G's 401(k) plan) or with a 401(m) arrangement (i.e., the matching contributions under Corporation G's 401(k) plan).[40] To preserve the qualification of Corporation L's plan, a nonelective contribution will have to be made to Corporation G's 401(k) plan because employer nonelective contributions under separate defined contribution plans may be permissively aggregated for coverage and nondiscrimination testing purposes.

3.13: Attribution of Ownership

As discussed earlier, **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. IRC §318 contains the attribution rules that are used for ASG purposes.

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. Where 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 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

[39] Treas. Reg. §1.410(b)-7(d)(5).
[40] Treas. Reg. §1.410(b)-7(c).

attribution to others (such as a family member). We will use the generic term interest to refer to these various forms of ownership.

FAMILY ATTRIBUTION

An individual is treated as owning any interest that is owned by the individual's spouse, children, grandchildren or parents.[41]

Spouse

If an individual and his or her spouse are legally separated under a decree of divorce or separate maintenance, there is no attribution.

EXAMPLE 3-37. Spousal Attribution. J is the 100 percent owner of Corporation T. J is married to L. L is also treated as a 100 percent owner of the corporation.

In IRC §1563(e)(5), the attribution used for controlled group determination, there is an exception to spousal attribution if the nonowner is uninvolved in the business and certain other conditions are met. There is no similar exception for purposes of IRC §318 attribution.

Parent/Child

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. A legally adopted child is treated as the individual's child for attribution purposes.[42]

EXAMPLE 3-38. Attribution from Parent to Child. Assume in Example 3-37 that J and L have three children. Each child is also treated as owning 100 percent of Corporation T because the stock owned by J is attributed to each of the children.

EXAMPLE 3-39. Attribution from Child to Parent. T's daughter is a 25 percent owner of Corporation Q. T is treated as owning 25 percent of Corporation Q because of the attribution of T's daughter's interest to T.

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, occurs regardless of the child's age. The rules for attribution under IRC §1563, which are used to determine whether two or more businesses constitute a controlled group under IRC §414(b) or (c), are different if the child is under age 21 than they are

[41] IRC §318(a)(1).
[42] IRC §318(a)(1)(B).

once the child has attained his or her majority. Under IRC §318 attribution, the rules do not distinguish between adult and non-adult children.

Grandparent/Grandchild

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 3-40. Attribution Between Grandparent and Grandchild. M owns 50 percent of the stock of Corporation Q. M's grandchild, P, owns the other 50 percent. M is treated as a 100 percent owner of Corporation Q because M is attributed the grandchild's ownership. P, however, is not treated as owning M's interest because an individual is treated as owning the parent's interest, but not the grandparent's interest.[43]

The attribution of the grandchild's interest to a grandparent occurs regardless of the level of ownership. The controlled group rules for attribution of ownership under IRC §1563 require that the individual to whom attribution is made own at least 50 percent of the company in his or her own right. Such requirement does not exist in IRC §318.

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.[44] This is known as the prohibition on double attribution.

EXAMPLE 3-41. No Double Attribution. F owns 100 percent of Corporation B. F has a child, N, who is married to W. F's 100 percent ownership interest is attributed to N, but it is not then attributed to W because of W's marriage to N. Although N is treated as owning 100 percent by attribution, that interest is not treated as owned by N for purposes of attributing that interest to N's spouse, W.

The purpose of the no double attribution rule is to prevent multiple tiers of family attribution. That way, an individual's indirect ownership through attribution is not then treated as direct ownership to be applied in yet another round of family attribution. However, it does not affect multiple attributions when an owner is related to two or more family members.

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[43] Example in Treas. Reg. §1.318-2(b).
[44] IRC §318(a)(5)(B).

EXAMPLE 3-42. More than One Child. H owns 40 percent of Corporation W. H has three children. Each child is treated as owning 40 percent of Corporation W through the attribution rule described above. The attribution of H's stock to more than one child is not double attribution, because the reason for the attribution is each child's relationship to H. However, because of the no double attribution rule, if any child is married, that child's spouse is not attributed the stock that is attributed from H to that child.

Siblings

There is no attribution under IRC §318 between siblings.

EXAMPLE 3-43. Siblings. S and P are brother and sister. S owns 50 percent of Company X. P is not attributed S's ownership interest in Company X.

C is S and P's mother. S's interest in Company X is attributed to C, because C is S's mother. However, the stock attributed to C is not again attributed to, P, because of the no double attribution rule described above.

Summary of Family Attribution under IRC §318

- Attribution between spouses;
- Attribution from parent to child;
- Attribution from child to parent;
- Attribution from grandchild to grandparent;
- No attribution from grandparent to grandchild; and
- No attribution between siblings.

ATTRIBUTION FROM AN ORGANIZATION

Generally, if an organization (i.e., the parent) owns some or all of another organization (i.e., the subsidiary), that ownership is attributed proportionately to individuals who are owners of the parent organization. While the parent's ownership is always attributable to the owners if the parent is a partnership, S corporation or LLC, the attribution is made to corporate shareholders only if they own 50 percent or more of the parent corporation. A trust's ownership of a company is attributed to both the trust's creator (called the grantor) and to the trust's beneficiary.

ATTRIBUTION TO AN ORGANIZATION

There also may be attribution from an individual or entity to an organization it owns. For example, if a person owns at least 50 percent of a corporation, the individual's ownership of another entity is attributed to the corporation. A partnership will be attributed ownership interests of one of its partners in another organization. There are similar rules that apply to S corporations, LLCs and trusts (to which a grantor's or beneficiary's interest may be attributed).

3.14: Review of Key Concepts

- List the plan qualification rules that are affected by controlled group status and how they are affected.
- Define a parent-subsidiary controlled group.
- Define a brother-sister controlled group.
- Explain the common control test.
- Explain the effective control test.
- When is controlled group status determined?
- Which IRC section outlines the attribution rules that apply to the determination of controlled groups?
- What are the exceptions to spousal attribution for controlled groups?
- Explain the attribution rules applicable to minor children, adult children, parents, grandparents and grandchildren for controlled groups.
- What is the prohibition against double attribution?
- List the types of affiliated service groups and the rules that make two or more businesses an affiliated service group.
- What is a professional service corporation?
- Under what conditions must an FSO be a professional service corporation?
- What is a service organization?
- What types of entities that are part of an affiliated service group are required to be service organizations?
- How is it determined that a B-Organization derives a significant portion of its business from an FSO or an A-Organization?
- Describe a recipient organization and a management organization.
- Determine, based on the type and degree of services performed, whether the organization is a management organization.
- List the plan qualification rules that are affected by affiliated service group status.
- What is the effect of being an affiliated service group?
- What are the IRC §318 attribution rules that apply to affiliated service groups?

3.15: For Practice – True or False

1. A parent-subsidiary controlled group exists if the companies are connected through at least 50 percent stock ownership.
2. A brother-sister controlled group exists if either the common ownership or the effective control test is satisfied.
3. Attribution between spouses does not apply if the couple is childless.
4. Attribution from a parent to a minor child applies only if the parent owns more than 50 percent of the business.
5. Company A and Company B are a controlled group. The workforces of both companies are considered when testing each company’s plan for coverage requirements.
6. A financial institution is considered a service organization because it provides a service of lending money.

7. In order for an A-Org group to exist, the A-Organization must have at least a 10 percent ownership interest in the FSO.
8. If an FSO is a corporation, it always must be a professional service corporation for affiliated service group rules.
9. If two or more entities are deemed to be an affiliated service group, they do not need to be tested together for top-heavy purposes as long as each is not top-heavy on its own.
10. If two or more entities are deemed to be an affiliated service group and each entity sponsors its own plan, each plan must pass coverage.
11. For purposes of determining any type of affiliated service group, ownership is attributed from a grandchild to a grandparent, but not from a grandparent to a grandchild.

3.16: Sample Test Questions

1. Based on the following information, determine brother-sister controlled group status:

- The individuals listed are not related

Individual	W Corporation	X Corporation	Y Corporation
A	50%	40%	56%
B	0%	19%	17
C	50%	16%	11%
D	0%	25%	16%
Total	100%	100%	100%

   A. None
   B. W and X only
   C. W and Y only
   D. X and Y only
   E. W and X, X and Y only

2. All of the following conditions are necessary to avoid spousal attribution for controlled group purposes, EXCEPT:

   A. The spouse must not have any direct ownership in the business.
   B. The spouse must not be a director or employee of the business.
   C. The spouse must not participate in the management of the business.
   D. The spouse must not inherit the business upon death of the business owner.
   E. No more than 50 percent of the business' gross income may be derived from passive investments.

3. All of the following statements regarding attribution for controlled group purposes are TRUE, EXCEPT:

   A. Ownership is attributed from husband to wife unless the business is wholly owned by the husband and certain requirements are met.
   B. Ownership is attributed from a minor child to a parent.

C. Ownership is attributed from an adult child to a parent if the parent owns more than 50 percent of the corporation.
D. Ownership is attributed from a grandparent to a grandchild if the grandchild owns more than 50 percent of the corporation.
E. Ownership is attributed from a father-in-law to a son-in-law.

4. All of the following IRC sections consider controlled group members as a single-employer, EXCEPT:

A. Eligibility and coverage (IRC §410)
B. Deduction (IRC §404)
C. Top-heavy (IRC §416)
D. Vesting (IRC §411)
E. Annual additions (IRC §415)

5. All of the following statements regarding affiliated service groups are TRUE, EXCEPT:

A. An FSO can be part of both an A-Org group and a B-Org group.
B. An FSO of an A-Org group must be a professional service organization.
C. An A-Organization must be a service organization.
D. A B-Organization need not be a service organization.
E. An A-Organization must have some ownership in the FSO.

6. All of the following are effects of being an affiliated service group, EXCEPT:

A. An employee's service with all group members is credited when determining plan eligibility.
B. Plans must satisfy coverage requirements considering all employees in the affiliated service group.
C. HCE status is determined by looking at the ownership in each entity separately.
D. Annual additions for all plans in the group are aggregated to determine if the IRC §415 limits have been exceeded.
E. An employee's service with all group members is credited when determining vesting percentages.

7. All of the following statements regarding attribution in determining affiliated service groups are TRUE, EXCEPT:

A. Ownership interest is attributed between spouses.
B. Ownership interest is attributed from parent to adult child only if the parent owns more than 50 percent of the company.
C. Ownership interest is not attributed between siblings.
D. Ownership interest is attributed from grandchild to grandparent.
E. Ownership interest is not attributed from grandparent to grandchild.

8. All of the following activities would be considered management functions, EXCEPT:

A. Supervisory roles
B. Hiring employees
C. Investing 401(k) plan assets
D. Setting employee compensation

E. Business planning

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

3.17: Solutions to True or False Questions

1. False. The companies must be connected by at least 80 percent of stock ownership to satisfy the parent-subsidiary requirements.
2. False. Both the common ownership and the effective control tests must be satisfied for a brother-sister controlled group to exist.
3. False. For the spousal exception from attribution to apply, the individuals must not have direct ownership in each other's businesses, they must not participate in the management of each other's businesses, no more that 50 percent of the gross income of the businesses may be derived from passive investments, and the spouse's ownership interest may not be subject to disposition restrictions. In addition, whether the individuals reside in a community property state may affect the ability to satisfy the exception.
4. False. Attribution applies to minor children regardless of the amount owned by the parent.
5. True.
6. False. A financial institution is not a service organization.
7. False. While an A-Org group must have some ownership interest in the FSO, there is no minimum percentage requirement.
8. False. If an FSO is a corporation, it need only be a professional service corporation if it is part of an A-Org group. This requirement does not apply to B-Org groups.
9. False. Plans must be aggregated for top-heavy purposes.
10. True.
11. True.

3.18: Solutions to Sample Test Questions

1. The answer is **D**. Corporations W and X have common ownership of 56 percent and, therefore, do not satisfy the common control test even though they satisfy the effective control test (56 percent). Corporations X and Y have common ownership of 100 percent and effective control of 84 percent so the controlled group requirements are satisfied. Corporations W and Y have common ownership of 67 percent and, therefore, do not satisfy the common control test, even though they satisfy the effective control test (61 percent).
2. The answer is **D**. The business owner's interest cannot be subject to legal restrictions on sale or transfer without the approval of the spouse (for example, an option to buy the business owner's interest or a right of first refusal under which the spouse gets the first opportunity to buy the interest before it is sold to anyone else). However, this does not mean that the spouse cannot inherit the business.
3. The answer is **E**. Ownership may be attributed from a father to a daughter but would not be attributed to the daughter's husband.
4. The answer is **B**. Generally, for deductibility purposes, controlled group members are not treated as a single-employer. If the members participate in the same plan, they may be treated as a single-employer.
5. The answer is **B**. FSOs in an A-Org group must be professional service organizations only if they are corporations. If the FSO is a partnership or a sole proprietorship, this rule does not apply.

6. The answer is **C**. HCE status is determined by treating the affiliated service group members as a single-employer.
7. The answer is **B**. Ownership is attributed from parent to child no matter the age—the adult reference in the answer was a red herring. Do not confuse the attribution under IRC §318 used for the affiliated service group rules with that of IRC §1563 used for controlled group determinations.
8. The answer is **C**. The law does not define management functions. However, the term should be interpreted under common business practices. Investing 401(k) assets would not be a management function. It would be a role for the plan trustee.

CHAPTER 4:

COMPENSATION

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4.01: Key Terms

- Compensation ratio test
- IRC §415 compensation
- Current includible compensation
- First few weeks rule
- IRC §401(a)(17) compensation limit
- IRC §414(s) compensation
- Reasonable definition rule
- W-2 compensation
- Wages for income tax withholding

4.02: Introduction

Compensation is remuneration for an employee's personal services to the employer. Compensation is important because it is used to:

- Calculate the limitations under IRC §415;
- Determine whether an employee is highly compensated;
- Perform nondiscrimination testing;
- Determine an employee's allocation of contributions and forfeitures in a defined contribution plan;
- Determine an employee's minimum benefit or contribution under the top-heavy rules; and
- Calculate the employer's tax deduction for contributions.

The definition of compensation may differ for each of these purposes. Sometimes the definition of compensation is mandated by law. At other times, the plan sponsor may define compensation in a myriad of ways, often with as much creativity as desired. At still other times, the employer's latitude in defining compensation for use in the plan is limited by its ability to show that such a definition is not discriminatory in favor of highly compensated employees (HCEs).

4.03: IRC §401(a)(17) Compensation Limitation

For employee benefit plan purposes, compensation is limited to a dollar amount specified in Internal Revenue Code (IRC) §401(a)(17). The initial dollar amount was $200,000, but it has been (and will continue to be) adjusted by the cost-of-living index. The **IRC §401(a)(17) compensation limit** for 2020 is $285,000 and for 2019 is $280,000.

The IRC §401(a)(17) limit applies to compensation for most of the purposes discussed in this chapter, including IRC §415 compensation, IRC §414(s) compensation, compensation for allocation purposes and compensation for deduction purposes.

The §401(a)(17) limit is determined each January 1st, and the limit is applicable to any plan year that begins during that calendar year.

EXAMPLE 4-1. Compensation Limitation for an Off Calendar Year. The compensation dollar limitation under §401(a)(17) determined on January 1, 2019, is $280,000, and the limitation determined on January 1, 2020, is $285,000.

Corporation X's profit-sharing plan has a plan year that begins on June 1, 2019, and ends on May 31, 2020. The §401(a)(17) limit for this plan year is $280,000.

4.04: IRC §415 Compensation

A reference to **IRC §415 compensation** is a reference to compensation defined for purposes of applying the limitations under IRC §415. This is a complex compensation definition and may include and exclude many types of compensation. Care must be applied to make sure the compensation data is accurate when applying the limitations under IRC §415. The impact is significant and can affect many things as discussed below.

WHEN MUST A PLAN USE IRC §415 COMPENSATION TO DETERMINE COMPENSATION?

A plan is required to use IRC §415 compensation to apply the limits on allocations and benefits under IRC §415. However, the use of IRC §415 compensation is also required for:

- Identifying HCEs;
- Identifying key employees;
- Calculating minimum benefits or contributions for non-key employees and/or key employees under top-heavy plans; and
- Determining certain minimum contributions (i.e., "gateway" contributions) that must go to participants in plans that use "cross-testing" as a means of demonstrating nondiscrimination in favor of HCEs.

The definition of compensation for allocating employer contributions may be (but is not required to be) IRC §415 compensation. Also, compensation used to perform nondiscrimination testing may be (but is not required to be) based on IRC §415 compensation.

PERMISSIBLE IRC §415 COMPENSATION DEFINITIONS

There are three permissible definitions of IRC §415 compensation:

I. Current includible compensation;
II. W-2 compensation; and
III. Wages for income tax withholding (IRC §3401 Compensation).

Current Includible Compensation

The first permissible definition of IRC §415 compensation is current includible compensation. Current includible 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.[1] This definition includes overtime, bonuses,

[1] Treas. Reg. §1.415(c)-2(b).

commissions, tips, fringe benefits (e.g., 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.[2]

Because workers' compensation is excludable from gross income,[3] such amounts would not be included in IRC §415 compensation.

Amounts Specifically Noted as IRC §415 Compensation

The regulations specify certain types of income that are included in this definition of compensation.[4] These amounts are set forth separately because the Internal Revenue Service (IRS) prescribes a safe harbor rule in the regulations under which these amounts may be excluded from the plan's definition of IRC §415 compensation, even though they are normally included in this definition.[5]

Medical/disability benefits. Medical or disability benefits that are includible in gross income under IRC §§104(a)(3), 105(a) or 105(h) are included in this definition of compensation. IRC §104(a)(3) includes income disability benefits that are paid through insurance to the extent the insurance premiums were paid by the employer.

Moving expenses. If it is not reasonable to believe moving expenses paid or reimbursed by the employer are deductible by the employee, the amount paid or reimbursed for such expenses are included in this definition of compensation.

Stock options. A nonqualified stock option is included in this definition of compensation, but only if it is includible in gross income in the year in which it is granted.

IRC §83 property. An employer may give an employee property, rather than cash, for services rendered. Sometimes that property is restricted so that the ownership of the property returns to the company if the employee leaves within a period of time or takes other specified action. If property is subject to such restrictions, it may not be taxable to the employee until those restrictions are lifted. However, an employee may make an election under IRC §83(b) to have such property taxed when received, rather than when the restrictions lapse (which is common if the employee expects the property to appreciate in value during the interim period). If an employee makes such an election, the amount includible in gross income because of that election is included in this definition of compensation.

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[2] Treas. Reg. §1.415(c)-2(g)(5).
[3] IRC §104(a)(1).
[4] Treas. Reg. §1.415(c)-2(b).
[5] Treas. Reg. §1.415-2(d)(10).

Certain compensation attributable to nonqualified plans. Section 415 compensation includes amounts contributed to a nonqualified plan that are includible in income by reason of IRC §409A or IRC §457(f)(1)(A), or because the amounts are constructively received by the employee.[6]

Certain elective deferrals treated as compensation. Elective deferrals under a 401(k) arrangement, a 403(b) program or a SARSEP are included in determining IRC §415 compensation.[7]

Amounts Specifically Excluded from IRC §415 Compensation

Section 415 compensation does not include the amounts discussed below.[8] These exclusions apply regardless of whether the plan applies the current includible compensation definition or the safe harbor version of this definition described below.

Contributions to deferred compensation plan. Employer contributions to a plan of deferred compensation, whether qualified or nonqualified, are excluded to the extent that the amounts are not includible in the employee's gross income for the taxable year in which contributed (determined before the application of the IRC §415 limits, in the case of a qualified plan). This applies both to unfunded and funded deferred compensation arrangements, including contributions to a qualified plan under IRC §401(a), contributions to a SEP or SIMPLE-IRA plan and contributions to a rabbi trust maintained as part of an unfunded deferred compensation plan.

Contributions an employer makes to a deferred compensation plan that are not elective deferrals under a 401(k) or 403(b) arrangement (e.g., matching contributions or nonelective contributions) or under a SARSEP (e.g., discretionary employer contributions to a SEP), are excluded from IRC §415 compensation.

EXAMPLE 4-2. Treatment of Contributions to Deferred Compensation Plan. A corporation maintains a 401(k) plan. An employee's taxable wages for the year total $33,000. During the year, the employee contributed $2,000 to the 401(k) plan, and the corporation made a matching contribution in the amount of $1,000. The employee's IRC §415 compensation under this definition is $35,000, which includes the employees taxable wages and the 401(k) contribution. The $1,000 matching contribution is not added in to determine IRC §415 compensation because that amount is an employer contribution to a deferred compensation plan and is not an elective deferral that is included in IRC §415 compensation.

Distributions from deferred compensation plan. Distributions from a deferred compensation plan are excluded from IRC §415 compensation, even if the distributions are includible in gross income when distributed, except as described below.

If an employee receives an amount from an unfunded nonqualified plan, the IRC §415 compensation definition may (but is not required to) include such amount to the extent it is includible in the employee's gross income. The reason for treating distributions from unfunded

[6] Treas. Reg. §1.415(c)-2(b)(7). This rule was added by the 2007 regulations.
[7] IRC §415(c)(3)(D).
[8] Treas. Reg. §1.415(c)-2(c).

plans differently is that these distributions are reported as wages by the employer and are included on Form W-2, whereas distributions from funded arrangements are reported as plan distributions and reported on Form 1099-R. Distributions from unfunded deferred compensation plans may not be included in this definition of IRC §415 compensation unless the plan specifically provides for such inclusion. Note that distributions from an unfunded plan would include payments from a rabbi trust, because the maintenance of a rabbi trust does not cause the underlying deferred compensation plan to be treated as a funded plan.

Stock options. Amounts realized from the exercise of a nonqualified stock option (i.e., nonstatutory stock option), or amounts includible in income when restricted stock or property (as described in IRC §83) becomes freely transferable or no longer subject to a substantial risk of forfeiture, are excluded from IRC §415 compensation. Also, amounts realized from the sale, exchange or disposition of qualified stock options (i.e., incentive or statutory stock options) are excluded.

Other amounts receiving special tax benefits. Amounts that receive special tax benefits, such as premiums for group term life insurance (but only to the extent the premiums are not includible in gross income) and employer contributions to a 403(b) plan (whether or not excludable from gross income), are excluded from this definition of IRC §415 compensation.

Safe Harbor Rule

Under the safe harbor rule, a plan may modify the definition of IRC §415 compensation by specifically excluding certain amounts that are normally included—that is, medical/disability benefits, moving expenses, stock options and IRC §83 income.[9]

Many plan documents that use the current includible income definition of IRC §415 compensation adopt the safe harbor rule. The plan document must specify that it is using the safe harbor rule in order for this modified definition to be used for IRC §415 compensation purposes.

The safe harbor rule would result in the reduction of an employee's IRC §415 compensation under the current includable income definition if an employee earns compensation of the type that the safe harbor rule excludes.

W-2 Compensation

Under the **W-2 compensation** definition, IRC §415 compensation is defined as wages 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.[10]

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[9] Treas. Reg. §1.415(c)-2(d)(2).
[10] Treas. Reg. §1.415(c)-2(d)(4).

Wages under IRC §3401 are **wages for income tax withholding purposes**. Therefore, the W-2 definition is similar to the wages definition for FICA purposes (which will be discussed in Section 4.04[B].3 below), but is 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" shown on Form W-2.

Amounts Included in W-2 Compensation under IRC §415

Noncash Payments. This definition of compensation includes the cash value of payments made in a form other than cash (e.g., taxable portion of company automobile).[11]

Foreign Income. For income tax purposes, payments representing earned income for services rendered outside of the US that are made to a US citizen are not included in the W-2 definition of compensation if it is reasonable to believe that such amounts are excluded from gross income under IRC §911 (relating to the foreign income exclusion).[12] However, for IRC §415 purposes, these amounts should be included, because provisions that limit the remuneration included as wages based on the location of the employment are disregarded.

Distributions from an Unfunded Nonqualified Plan. Distributions from an unfunded nonqualified plan are included in the W-2 definition of compensation. Deemed distributions under IRC §409A—which applies to nonqualified deferred compensation deferred in post-2004 tax years—are also wages for W-2 purposes.

Amounts Excluded from W-2 Compensation under IRC §415

Reimbursements. Payments made under a reimbursement or other expense allowance arrangement are excluded if the amounts are treated as paid under an accountable plan (as defined in IRC §62 and Treas. Reg. §1.62-2).

Moving Expenses. Qualified moving expenses an employer pays to a third party (e.g., a moving company) and services an employer furnishes in kind to the employee are excluded. In addition, qualified moving expense reimbursements paid to the employee (i.e., those expenses that are reasonably believed to be deductible by the employee) also are excluded. Nonqualified moving expense reimbursements are reported on Box 1 of W-2 and are subject to withholding.[13]

Workers' Compensation. Payments that are made because of a work-related injury or sickness, pursuant to workers' compensation law, are not considered sick pay and are not reported as wages by the employer.[14]

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[11] Treas. Reg. §§1.415(c)-2(b)(1); 1.6041-2.
[12] Treas. Reg. §1.6041-3(f).
[13] For more information on moving expenses, see IRS Publication 521.
[14] IRS Publication 15-A.

Wages for Income Tax Withholding (IRC §3401 Compensation)

The third permissible definition of IRC §415 compensation is wages for income tax withholding. Under this definition, IRC §415 compensation is defined as wages under IRC §3401(a) for purposes of income tax withholding at the source or **wages for income tax withholding**.[15] Any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed are disregarded. IRS Publication 15–Circular E, Employer's Tax Guide, and Publication 15-A−Employer's Supplemental Tax Guide, provide helpful instructions on the treatment of compensation as wages for income tax withholding purposes. All amounts included in this definition would also be included in the W-2 definition described above, so this definition is a less inclusive definition than the W-2 definition.

Types of Wages Generally Included

The term wages under IRC §3401(a) generally means all remuneration for services performed by an employee, unless specifically excepted under IRC §3401(a). How the employer might name the remuneration (salaries, fees, bonuses or commission on sales or on insurance premiums) does not affect the treatment of the amount as wages.[16] The regulations include references to pensions and retired pay, but certain types of such payments are specifically excluded (e.g., payments from qualified plans). However, payments under unfunded nonqualified deferred compensation plans are generally included, because they are treated as wages when paid.

Wages may be based on time (e.g., hourly, daily, weekly, monthly or annually), piecework or a percentage of profits.[17] Furthermore, the medium of payment is not relevant; wages may be paid in cash, stocks, bonds or other property.[18]

Vacation pay. Amounts paid to an employee on vacation are includible wages, even though the employee is absent from work and is not performing services.[19]

Disability or sick pay. Payments for disability, to the extent attributable to employer contributions (through insurance or otherwise), are generally included in the definition of wages. Similarly, sick pay is also considered wages even though the employee is not performing services during the employee's absence.[20] The IRS refers to sick pay as any amount paid under a plan or system because of an employee's temporary absence from work due to injury, sickness or disability. Generally, sick pay is reported as wages on the W-2 and is subject to federal income tax withholding if the payment is made directly by the employer or by a third-party agent of the employer. A third party is an agent only if the third party bears no insurance risk and is reimbursed on a cost-plus-fee basis for payment of sick pay and similar amounts. If the third party is an insurer and the third party is liable for the income tax withholding, the employer would not report those

[15] Treas. Reg. §1.415(c)-2(d)(3).
[16] Treas. Reg. §31.3401(a)-1(a)(2).
[17] Treas. Reg. §31.3401(a)-1(a)(3).
[18] Treas. Reg. §31.3401(a)-1(a)(4).
[19] Treas. Reg. §31.3401(a)-1(b)(3).
[20] Treas. Reg. §31.3401(a)-1(b)(8).

amounts on the W-2 unless the third party has met the IRS' requirements for transferring liability for the income tax withholding to the employer.[21]

Payments that are made because of a work-related injury or sickness, pursuant to workers' compensation law, are not sick pay and are not reported as wages by the employer.[22]

Reimbursements. Payments made under a reimbursement or other expense allowance arrangement are excluded if the amounts are treated as paid under an accountable plan (as defined in IRC §62 and Treas. Reg. §1.62-2).[23] These amounts are not reported in Box 1 of W-2, so they are also excluded from the W-2 compensation definition of IRC §415 compensation.

Fringe benefits. Only taxable fringe benefits are subject to federal income tax reporting. These fringe benefits are reported in Box 1 of W-2 and are also included in the W-2 compensation definition described above. Nontaxable fringe benefits are not subject to federal income tax withholding, so are not included in this definition of compensation. Because these amounts are not includible in Box 1 of Form W-2 nor gross income, they are not part of the W-2 or current includible income definitions of compensation. Nontaxable fringe benefits include:

- A no-additional-cost service provided to the employee, which is provided by the employer in the ordinary course of business to customers (e.g., free airline tickets to airline employees);
- Qualified employee discounts, if not more than the employer's gross profit percentage;
- Working condition benefits (e.g., company car for business use);
- *De minimis* benefits (i.e., service or item of small value, such as occasional personal use of office copier, dinner money or cab fare);
- Qualified transportation benefits (e.g., transit passes, qualified parking);[24]
- On-site gym or other athletic facilities, if substantially all the use is by employees, their spouses and their dependent children; and
- Qualified tuition reduction.[25]

Qualified transportation benefits purchased through salary reduction. Although qualified transportation benefits are not included in Box 1 of W-2 if they are purchased through salary reduction, they will be included when compensation is "grossed up" for elective deferrals.

Distributions from an Unfunded Nonqualified Plan. Distributions from an unfunded nonqualified plan are included in this definition of compensation. Deemed distributions under IRC §409A—which applies to nonqualified deferred compensation deferred in post-2004 tax years—are also wages for income tax withholding purposes.

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[21] IRS Publication 15-A, sick pay.
[22] *Id.*
[23] Treas. Reg. §31.3401(a)-4.
[24] IRS Publication 535.
[25] IRS Publication 520.

Housing Allowance for Minister Not Included

The IRS has privately ruled that a housing allowance for a "minister of the gospel," as described in IRC §107, is not included in the definition of wages under IRC §3401(a) and, thus, may not be counted as IRC §415 compensation under the W-2 and IRC §3401(a) definitions.[26]

Other Compensation Issues

Self-Employed Individuals

If an individual is self-employed as defined in IRC §401(c)(1) with respect to the employer that sponsors the plan, IRC §415 compensation from that employer means earned income as defined in IRC §401(c)(2), regardless of which of the three definitions of IRC §415 is used for the other participants.[27] (See Chapter 2 for an explanation of earned income.) 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 for self-employment taxes, as described 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 for self-employment taxes pursuant to IRC §401(c)(2)).

Independent Contractors

Remuneration paid by a plan sponsor to an independent contractor (usually reported on Form 1099-MISC) would not be treated as IRC §415 compensation from the plan sponsor. A qualified plan may cover only employees and former employees of the sponsoring employer. However, the independent contractor might be a self-employed individual, within the meaning of IRC §401(c)(1), with respect to his or her own trade or business (e.g., sole proprietorship), so payments received for his or her services might constitute earned income with respect to that trade or business.

EXAMPLE 4-3. Independent Contractor Who is a Sole Proprietor.
Corporation X retains R, a consultant, to provide services under an independent contractor relationship. R is a sole proprietor (i.e., R is unincorporated with respect to R's business activities and files Schedule C with R's federal income tax return to report the income derived from those business activities). Corporation X pays R $20,000 during the current calendar year and reports the payment on Form 1099-MISC. The payment is not IRC §415 compensation from Corporation X. However, the payment is included in R's calculation of earned income from R's sole proprietorship. If R's sole proprietorship maintains a plan, that earned income will be used as R's IRC §415 compensation with respect to that plan.

[26] PLR 200135045.
[27] Treas. Reg. §1.415(c)-2(b)(3).

(This example assumes R's sole proprietorship and Corporation X are not related employers under IRC §§414(b), (c) or (m)).

WHICH DEFINITION APPLIES?

The IRS requires the choice of compensation definition to be stated in the document.[28]

Differences Among the Definitions

For the typical employee whose compensation is paid entirely in the form of wages, salary, overtime, bonuses and/or commissions, the three definitions produce the same amount of compensation. Certain forms of compensation are specifically addressed below because of special income issues relating to such forms of compensation or because such items might be treated differently under the three definitions of IRC §415 compensation.

Tips

The current includible compensation definition includes all tips. In contrast, the W-2 definition and the wages for income tax withholding definition exclude non-cash tips[29] and cash tips of less than $20 per month.[30]

IRC §3401(f) treats tips as wages when the employer provides the employee with a written statement including such tips, pursuant to IRC §6053(a). If no statement is furnished, then tips are treated as wages when received by the employee. Generally, withholding on tips that are treated as wages can be taken from non-tip wages. If the non-tip wages are not sufficient to cover the withholding liability, the employer is not required to withhold, unless the employee turns over sufficient funds to cover the withholding, pursuant to IRC §3102(c)(2) or IRC §3202(c)(2).[31]

The employer can satisfy withholding using tips received by credit card. In this case, the employer would simply reduce the amount of cash it pays the employee for such tips. This can be useful in making salary reduction contributions under a 401(k) plan.

Medical Benefits

Amounts paid under accident and health plans that are includible in income generally are included in the W-2 and the wages for income tax withholding definitions. These amounts may be (although are not required to be) excluded under the current includible compensation definition.

Group Term Life Insurance

Group term life insurance provided by the employer, to the extent it is includible in the employee's gross income, is included in the current includible compensation definition and in the W-2

[28] Quality Assurance Bulletin on incorporation by reference in plan documents (posted at www.irs.gov).
[29] IRC §3401(a)(16)(A).
[30] IRC §3401(a)(16)(B). IRS Publication 531 discusses the reporting of tip income. Also see the instructions for Box 8 of Form W-2, the description of tips in IRC §3402(k), and the instructions to IRS Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips.
[31] IRC §3401(k).

definition. However, IRC §3401(a)(14) exempts such amounts from the wages for income tax withholding definition.

Stock Options

The stock option exclusion, with respect to nonqualified stock options, is found in the current includible compensation definition in the regulations. However, it does not apply to the W-2 definition or to the wages for income tax withholding definition. Amounts realized from the sale, exchange or disposition of qualified stock options (also known as *incentive stock options* or *statutory stock options*) are excluded under all three definitions.

Nonqualified Plan Distributions

Distributions from an unfunded, nonqualified plan are included in the W-2 definition and the wages for income tax withholding definition. The current includible compensation definition normally excludes these amounts, but the plan may provide for the inclusion of these amounts.

Deemed distributions under IRC §409A—which applies to nonqualified deferred compensation deferred in post-2004 tax years—are also wages for income tax withholding and W-2 purposes.[32]

Contributions to Unfunded Nonqualified Plans

All three definitions treat contributions to unfunded plans in the same manner. Contributions to an unfunded nonqualified plan (e.g., to a rabbi trust) would be compensation (reportable on W-2 and subject to federal income tax withholding) when they are actually or constructively received by the employee. This is true even though the contributions might be subject to FICA tax at an earlier time. FICA tax on unfunded, nonqualified deferred compensation is required when the contributions are no longer subject to a substantial risk of forfeiture.[33]

Contributions to Funded Nonqualified Plans

All three definitions also treat contributions to funded nonqualified plans in the same manner. These contributions are compensation (reportable on W-2 and subject to federal income tax withholding) when they are no longer subject to a substantial risk of forfeiture under the principles discussed in IRC §§83 and 402(b).

Comparison Table

The table below indicates whether each listed item is included or excluded in each of the four possible definitions: current includible compensation definition, safe harbor rule under the current includible compensation definition, W-2 compensation definition and wages for income tax withholding definition.

[32] IRC §3401(a), as amended by the American Jobs Creation Act of 2004.
[33] IRC §3121(v)(2).

Item of Compensation	Current Includable Compensation	Safe Harbor Definition	W-2	Federal Withholding Wages
Salary	Included	Included	Included	Included
Overtime	Included	Included	Included	Included
Bonuses	Included	Included	Included	Included
Commissions	Included	Included	Included	Included
Tips	Included, but allocated tips are arguably excepted	Same as current includible compensation	Exclude allocated tips, noncash tips, tips under $20 per month	Same as W-2
Elective deferrals	Included	Included	Included	Included
Expense reimbursements – accountable plan	Excluded	Excluded	Excluded	Excluded
Expense reimbursements – nonaccountable plan	Included	Included	Included	Included
“Qualified” moving expense reimbursements	Excluded	Excluded	Excluded	Excluded
“Nonqualified” moving expense reimbursements	Included	Excluded	Included	Included
Nontaxable fringe benefits	Excluded	Excluded	Excluded	Excluded
Taxable fringe benefits	Included	Included	Included	Included
“Excess” group term life insurance	Included	Included	Included	Excluded
Taxable medical or disability benefits	Included	Excluded	Included	Included
Workers’ compensation	Excluded	Excluded	Excluded	Excluded
IRC §83 property that becomes freely transferable or no longer subject to substantial risk of forfeiture	Excluded	Excluded	Included	Included

Item of Compensation	Current Includable Compensation	Safe Harbor Definition	W-2	Federal Withholding Wages
Income attributable to IRC §83(b) election	Included	Excluded	Included	Included
Nonqualified plan contributions excludable in year of contribution	Excluded	Excluded	Excluded	Excluded
Nonqualified plan distributions	Excluded unless plan provides otherwise	Excluded unless plan provides otherwise	Included	Included
Qualified stock options – grant or exercise	Excluded	Excluded	Excluded	Excluded
Nonqualified stock option includible in income in year granted	Included	Excluded	Included	Included
Nonqualified stock option – income includible in year of exercise	Excluded	Excluded	Included	Included
Differential wage payments (IRC §3401(h))	Included	Included	Included	Included
Post-severance compensation that is "trailing compensation" meeting the 2½-month rule	Included	Included	Included	Included
Post-severance compensation that is un- used leave cashout meeting the 2½-month rule	Included only if plan provides	Included only if plan provides	Included only if plan provides	Included only if plan provides
Post-severance compensation relating to nonqualified deferred compensation pay- able without regard to	Included only if plan provides	Included only if plan provides	Included only if plan provides	Included only if plan provides

Item of Compensation	Current Includable Compensation	Safe Harbor Definition	W-2	Federal Withholding Wages
severance meeting the 2½-month rule				
Post-severance salary continuation for dis- abled participants	Included only if plan provides	Included only if plan provides	Included only if plan provides	Included only if plan provides
Post-severance salary continuation for military service (other than differential wage payments covered by The Heroes Earnings Assistance and Relief Tax, HEART)	Included only if plan provides	Included only if plan provides	Included only if plan provides	Included only if plan provides
Any other post-severance compensation	Excluded	Excluded	Excluded	Excluded

Gross Up for Pre-tax Elective Deferrals and Other Salary Reduction Amounts

The employee's IRC §415 compensation definition must include the following pre-tax elective deferrals:[34]

- All pre-tax elective deferrals described in IRC §402(g)(3) (i.e., pre-tax elective deferrals under a 401(k) arrangement, 403(b) plan, SIMPLE-IRA or SARSEP);
- Pre-tax catch-up contributions under 414(v);
- Pre-tax elective deferrals made to a cafeteria plan under IRC §125 or to a 457 plan; and
- Pre-tax elective deferrals used to purchase qualified transportation fringe benefits, pursuant to IRC §132(f)(4).

The three regulatory definitions of IRC §415 compensation focus on currently taxable income. Pre-tax elective deferrals and pre-tax catch-up contributions are excluded from income (with the exception of elective deferrals that are designated as Roth contributions under a 401(k) plan or 403(b) plan). Therefore, the compensation determined under all permissible definitions must be

[34] IRC §415(c)(3)(D).

increased (or grossed up) for the employee's total pre-tax elective deferrals and pre-tax catch-up contributions for the relevant period.

EXAMPLE 4-4. Determination of IRC §415 Compensation When There are Pre-Tax Elective Contributions. Suppose employee G's gross annual compensation is $30,000. During the year, G defers $1,000 to a 401(k) plan and $1,500 for cafeteria plan benefits, leaving G with net taxable compensation of $27,500. Because of IRC §415(c)(3)(D), the plan must increase the participant's IRC §415 compensation by adding back G's pre-tax elective contributions ($2,500). Thus, G's IRC §415 compensation is $30,000. This is the amount G's compensation would have been under any of the three definitions had G not elected to defer compensation under the 401(k) plan and not elected to further reduce compensation for the cafeteria plan benefits, and instead elected to receive those amounts as cash compensation. This way, participation by an employee in these elective deferral arrangements has no effect on the employee's compensation for IRC §415 purposes.

The earned income of a self-employed individual who is covered by the plan is also grossed up for pre-tax elective contributions and pre-tax catch-up contributions to determine IRC §415 compensation. IRC §415(c)(3)(D) does not restrict the gross-up rule to common law employees.

Elective Deferrals Made Through Automatic Enrollment

Pre-tax elective deferrals that are made through automatic enrollment are included in the gross-up under IRC §415(c)(3)(D), although there may be an issue regarding inclusion under certain automatic enrollment procedures in cafeteria plans. If the participant does not elect to receive cash or have a different reduction percentage or amount withheld, automatic enrollment allows the participant's compensation to be automatically reduced at a predetermined percentage of compensation or dollar amount. The IRS has expressly acknowledged the acceptability of automatic enrollment procedures under 401(k) plans,[35] 403(b) plans,[36] 457(b) plans,[37] and cafeteria plans.[38]

If You're Curious . . .

Government Pick Up Plans

Employee contributions that are picked up by a governmental employer, pursuant to IRC §414(h) (2) (known as a governmental pick up arrangement), are not treated as elective deferrals under IRC §415(c)(3)(D), so they would not be included in the IRC §415 compensation definition. This might be a Congressional oversight. However, the IRS has

[35] IRC §414(w); Treas. Reg. §1.401(k)-1(a)(3)(ii), Rev. Rul. 2000-8; IRB 2000-7.
[36] Rev. Rul. 2000-35, IRB 2000-31.
[37] Rev. Rul. 2000-33; IRB 2000-31.
[38] Rev. Rul. 2002-27; IRB 2002-27.

not issued any rules that would permit the inclusion of the picked up contributions in the employee's IRC §415 compensation.

Note on Qualified Transportation Benefits

Salary reduction deferrals that are used to purchase qualified transportation fringe benefits, as described in IRC §132(f)(4), as elective deferrals are added back when grossing up compensation for IRC §415 purposes. A qualified transportation fringe benefit includes the cost of transportation in a "commuter highway vehicle,"[39] any transit pass[40] and qualified parking.[41] If an employer allows employees to purchase qualified transportation fringe benefits through salary reduction, the salary reduction contributions must be included in IRC §415 compensation.

Designated Roth Contributions

When an employee makes designated Roth 401(k) contributions or Roth 403(b) contributions, the Roth deferrals shown in Box 12 of the W-2 will also appear in Box 1, because they are subject to income tax withholding. Compare this to the employee who makes pre-tax elective contributions, where the pre-tax elective deferrals also are reported in Box 12, but where the Box 1 amount does not include the pre-tax elective deferrals.

Because the designated Roth 401(k) contributions or Roth 403(b) contributions show up in both the Box 1 amount and in Box 12, administrators who take compensation information from the Form W-2 reporting need to make sure that they do not add the Roth contributions to the Box 1 compensation to arrive at gross compensation under IRC §415 and any plan definition that requires the grossing up for pre-tax elective deferrals.

Accrued Compensation

The IRC §415 compensation definitions are based on compensation paid during the limitation year. Compensation accrued but not paid during the year is not included.[42] This is true regardless of the employer's method of accounting. However, there is an exception, generally referred to as the "first few weeks" rule.

The regulations permit compensation for a limitation year to include amounts earned during the year but not paid until the next limitation year solely because of pay periods and pay dates if:

- The amounts are paid during the first few weeks of the next limitation year. The regulations do not define what constitutes the "first few weeks;"
- The amounts are included on a uniform and consistent basis with respect to all similarly-situated employees; and
- No compensation is included in more than one limitation year.[43]

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[39] IRC §132(f)(5)(B).
[40] IRC §132(f)(5)(A).
[41] IRC §132(f)(5)(C).
[42] Treas. Reg. §1.415(c)-2(e)(1)(i).
[43] Treas. Reg. §1.415(c)-2(e)(2).

This rule is available, regardless of whether the employer uses the cash method or the accrual method to report income.

EXAMPLE 4-5. First Few Weeks Rule. A plan measures IRC §415 compensation on a calendar year basis. An employee receives a paycheck on January 3. The payment relates to services for the period December 15 through 31. Under the first few weeks rule, the amount may be included in IRC §415 compensation for the prior year.

Severance Compensation

Severance compensation that is paid only because an employee has terminated service is not included as compensation under IRC §415.[44] However, accrued vacation or sick pay that would have been paid to an employee had he or she continued work and qualified for such amounts are includible in compensation if they are paid by the later of 2 ½ months after termination or the last day of the plan year in which the participant terminated employment.[45]

Related Employers

Related employers (i.e., employers that are considered to be part of a controlled group or affiliated service group) are aggregated under IRC §415. Therefore, an employee's IRC §415 compensation includes his or her compensation from all related employers. This is true regardless of whether the related companies maintain a single plan or separate plans. Even compensation paid by an employer within the related group who does not maintain a plan must be taken into account in computing IRC §415 compensation of an employee who participates in a plan maintained by another employer within the related group.

EXAMPLE 4-6. Compensation from Related Employer. D is employed by both Corporations A and B. The corporations constitute a controlled group of businesses as defined in IRC §414(b). D receives compensation from both corporations. To determine whether the IRC §415 limits are exceeded with respect to D's participation in any plan maintained by either corporation, D's IRC §415 compensation from both corporations must be aggregated. Thus, if Corporation A maintains a plan, but Corporation B does not, Corporation A's plan still must count D's compensation from Corporation B to compute D's IRC §415 compensation. Similarly, if each corporation maintains a separate plan, D's combined compensation from both businesses would be used to compute D's IRC §415 compensation under each plan.

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[44] Treas. Reg. §1.415(c)-2(e)(1)(ii).
[45] Treas. Reg. §1.415(c)-2(e)(3)(i).

Measurement Year

The measurement year for determining IRC §415 compensation depends on the purpose for which it is being used. When used to calculate the IRC §415 limits, the compensation is measured for the limitation year (as defined by the plan).[46] But the plan might also use the definition of IRC §415 compensation to determine compensation for other purposes, such as nondiscrimination testing under a 401(k) plan, or to determine how to allocate employer contributions. When used as the basis for computing IRC §414(s) compensation, the compensation is measured for the plan year or other compensation period being used by the plan to apply the nondiscrimination test. For example, in a defined contribution plan, the measurement period might be the plan year or a 12-month period, such as the calendar year, that ends in such plan year.

Plan's Definition for Allocation Purposes may be Different from IRC §415 Limit

A participant's IRC §415 compensation for purposes of applying the IRC §415 limit need not be the same as the compensation definition used for allocation 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 pre-tax elective contributions under a 401(k) plan, to determine compensation for allocation purposes, even though such amounts are included in determining an employee's IRC §415 compensation.

Differential Wage Payments

The Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART) amended the Code in relation to differential wage payments. These are payments made voluntarily by an employer to an employee on active duty with the U.S. uniformed services in an amount not exceeding the level of compensation the service member would have received had the individual been employed by the employer during the period of active duty. Before HEART, differential wage payments were not included as compensation, because the service member was treated as a terminated employee when he or she entered active service. However, HEART changed the nature of the employment relationship for plan purposes, thus permitting differential wage payments to be included as compensation if certain requirements are met.

The Code definition of differential wage payment is any payment that:

- is made by an employer to an individual with respect to any period during which the uniformed individual is performing service in the uniformed services while on active duty for a period of more than 30 days; and
- represents all or a portion of the wages that the individual would have received from the employer had he or she been performing services for the employer.[47]

[46] Treas. Reg. §1.415-2(e)(1)(i).
[47] IRC §3401(h)(2).

Effective for remuneration paid after December 31, 2008, the plan must treat differential wage payments as compensation for all purposes under the Code, and also to treat the individual receiving such payments as an employee of the employer, except to determine the eligibility of the individual for certain distributions. Therefore, differential wage payments are included in IRC §415 compensation, regardless of which of the three definitions is used.[48]

4.05: IRC §414(s) Compensation

IRC §414(s) defines what constitutes a nondiscriminatory definition of compensation. IRC §414(s) compensation is required to be used for purposes of applying the nondiscrimination tests to employer-provided contributions and benefits,[49] elective deferrals,[50] permitted disparity formulas,[51] matching contributions and after-tax employee contributions.[52]

Each of the IRC §415 compensation definitions is a safe harbor definition of IRC §414(s) compensation.[53] Therefore, any of these definitions is deemed to be nondiscriminatory.

Differential wage payments may be considered part of IRC §414(s) compensation, or may be excluded.[54] Therefore, a plan excluding differential wage payments will still be considered to be a design-based safe harbor plan if it otherwise qualifies.

SAFE HARBOR IRC §414(S) COMPENSATION BASED ON IRC §415 COMPENSATION

The regulations permit three safe harbor modifications to the IRC §415 compensation definitions in arriving at IRC §414(s) compensation:

A. Exclusion of fringe benefits and other special compensation items;
B. Treatment of elective deferrals in the opposite manner as they are treated under IRC §415 definition; and
C. Exclusions applied only to HCEs.

By treating these modifications as a safe harbor, the regulations permit these modified definitions of compensation to satisfy IRC §414(s) without any special testing required. In other words, the test described below to show nondiscrimination would not be required to demonstrate that the modified definitions of IRC §415 compensation satisfy IRC §414(s). All three (or any combination) of the modifications described below may be made to the IRC §415 compensation definitions without causing the definition to fail to satisfy IRC §414(s).

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[48] IRC §414(u)(12)(A)(i).
[49] IRC §401(a)(4).
[50] IRC §401(k).
[51] IRC §401(l).
[52] IRC §401(m).
[53] Treas. Reg. §1.414(s)-1(c)(2).
[54] Notice 2010-15, IRB 2010-6 (1/20/10), Q&A-10.

Exclusion of Fringe Benefits and Other Special Compensation Items

Fringe benefits (cash and noncash), reimbursements or other expense allowances, moving expenses, deferred compensation and welfare benefits may be excluded to determine IRC §414(s) compensation.[55] All of the listed items must be excluded for this modification to be a safe harbor. If only some, but not all, of such items are excluded, then the definition of compensation must be tested to determine if it satisfies IRC §414(s). By excluding these items, most of the differences between the three IRC §415 compensation definitions are eliminated.

EXAMPLE 4-7. Determining Employer Contribution Allocation. An employer makes contributions to a profit-sharing plan. The plan defines compensation for allocation purposes to be IRC §415 compensation, but modified to disregard the items listed in the prior paragraph. S is an HCE earning $120,000 per year. None of S’s IRC §415 compensation consists of these items, so 100 percent of S’s compensation is counted in determining S’s allocable share of the employer contribution to the plan. P is a nonhighly compensated employee (NHCE) earning $50,000 per year. The fringe benefits exclusion results in $4,000 of that compensation being disregarded to determine S’s allocable share of the employer contribution to the plan. Although the plan’s definition counts 100 percent of S’s compensation, but only 92 percent of P’s compensation, the definition is not discriminatory and is deemed to satisfy IRC §414(s).

Note that this only determines whether the definition of compensation is discriminatory. The manner in which the plan allocates the contributions (i.e., the allocation formula) would have to satisfy the nondiscrimination testing requirements of IRC §401(a)(4). However, if the allocation method was designed to be a “safe harbor” under Treas. Reg. §1.401(a)(4)-2(b), the use of this definition of compensation would enable the plan to satisfy the safe harbor test under that regulation.

EXAMPLE 4-8. Effect on Nondiscrimination Testing. Because the compensation definition in the prior example is nondiscriminatory, the employer may use that definition to apply the various nondiscrimination tests. For example, suppose the profit-sharing plan includes a 401(k) arrangement, and P’s 401(k) contribution for the plan year is $3,000. By using the same definition of compensation to run the actual deferral percentage (ADP) test under IRC §401(k), the employer would calculate P’s actual deferral ratio (ADR) for that plan year to be 6.52 percent ($3,000/$46,000) rather than 6 percent ($3,000/$50,000). This makes it easier for the plan to pass the ADP test.

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[55] Treas. Reg. §1.414(s)-1(c)(3).

The regulations do not define what deferred compensation means for purposes of this exclusion. It should be reasonable to apply the principles used to determine whether compensation is deferred compensation for purposes of the deduction rules under IRC §§404(a)(5) and (b),[56] or the principles used to determine whether compensation is deferred compensation for purposes of the FICA withholding rules under IRC §3121(v).[57]

Treatment of Elective Deferrals under IRC §414(s)

IRC §415(c)(3)(D) addresses the treatment of elective deferrals under the IRC §415 compensation definition. Elective deferrals are included in IRC §415 compensation. For purposes of the IRC §414(s) compensation definition, a safe harbor modification permits elective deferrals to be treated in the opposite manner as they are treated under the IRC §415 definition. Thus, IRC §415 compensation may be reduced by the amount of elective deferrals without causing the compensation definition to fall out of the IRC §414(s) safe harbor.

For this purpose, elective deferrals include:

- Those amounts described in IRC §402(g)(3) (i.e., elective deferrals under a 401(k) arrangement, 403(b) plan, SIMPLE-IRA or SARSEP);
- Elective deferrals made to a cafeteria plan under IRC §125 or to a 457 plan; and
- Elective deferrals used to purchase qualified transportation fringe benefits (pursuant to IRC §132(f) (4)).

Elective deferrals under a 401(k) arrangement or a 403(b) plan are treated in the same manner for this purpose, regardless of whether the deferrals are made on a pre-tax basis or are designated as Roth contributions, pursuant to IRC §402A.

A plan may include "deemed IRC §125 compensation" in the definition of IRC §415 compensation.[58] This is certain compensation that is contributed to a cafeteria plan pursuant to an automatic enrollment procedure that technically is not subject to IRC §125. Therefore, an exclusion of deferrals would similarly exclude this deemed IRC §125 compensation.

If You're Curious . . .

Deemed IRC §125 Compensation

Generally, amounts taken from a participant's compensation to pay for health benefits must be subject to a participant's election to have cash instead to be subject to IRC §125. However, an exception to this rule exists for amounts taken from a participant's pay for group health insurance if the reason why the participant could not certify that he or she has other health coverage (which would normally be a reason to permit the participant to elect out of the health plan and receive cash in lieu of the health benefit) is that the employer does not request or collect information about the employee's other health

[56] Treas. Reg. §1.404(b)-1T.
[57] Treas. Reg. §31.3121(v)(2)-1(b).
[58] Rev. Rul. 2002-27, I.R.B. 2002-27.

coverage. A model amendment to permit this treatment is available in Rev. Rul. 2002-27, 2002-1 CB 925 (5/19/2002).

Consistent Treatment of All Elective Deferrals Required

If an employer maintains more than one arrangement that provides for elective deferrals, such amounts under all such arrangements must be treated the same way in the compensation definition for the modification to be a safe harbor under IRC §414(s). For example, if cafeteria plan contributions are excluded from the definition, but 401(k) deferrals are included, the modification is not a safe harbor modification, and the compensation definition would have to be tested to determine if it satisfies IRC §414(s).[59]

EXAMPLE 4-9. Determining Employer Contribution Allocation. An employer makes contributions to a profit-sharing plan. The plan defines compensation for allocation purposes to be IRC §415 compensation, but modified to disregard elective deferrals. The employer maintains a cafeteria plan and the profit-sharing plan includes a 401(k) arrangement. M is an HCE earning $120,000 per year. M participates in neither the cafeteria plan nor the 401(k) arrangement. None of M's IRC §415 compensation is excluded under the plan's definition, so 100 percent of M's compensation is counted in determining M's allocable share of the employer contribution to the profit-sharing plan. P is an NHCE earning $50,000 per year. P defers $2,000 per year to the 401(k) arrangement, and $3,000 per year to the cafeteria plan. Under the plan's definition, $5,000, or 10 percent of P's compensation, is being disregarded to determine P's allocable share of the employer contribution to the profit-sharing plan. Although the plan's definition counts 100 percent of M's compensation but only 90 percent of P's compensation, the definition is not discriminatory and is deemed to satisfy IRC §414(s).

EXAMPLE 4-10. Effect on Nondiscrimination Testing. Because the compensation definition in the prior example is nondiscriminatory, the employer may use that definition to apply the various nondiscrimination tests. For example, by using the same definition of compensation to run the ADP test under IRC §401(k), the employer would calculate P's ADR for that plan year to be 4.44 percent ($2,000/$45,000) rather than 4 percent ($2,000/$50,000). This makes it easier to pass the ADP test.

[59] Treas. Reg. §1.414(s)-1(c)(4).

Exclusion Applied Only to HCEs

This safe harbor modification permits the IRC §415 compensation definition to be modified to exclude any item of compensation if such exclusion applies only to HCEs.[60] The plan may provide that the exclusion applies to some or to all of the HCEs.

EXAMPLE 4-11. Exclusion of Compensation Type for HCEs Only. To determine an employee's benefits under an employer's defined benefit plan, the plan calculates compensation as IRC §415 compensation, using the W-2 compensation definition, but excludes bonuses paid to HCEs. Bonuses paid to NHCEs are included. The definition automatically satisfies IRC §414(s).

Treatment of Benefits Based on Differential Wage Payments for Nondiscrimination Testing Purposes

An employer may decide to include differential wage payments as part of plan compensation for purposes of providing contributions or benefits. The portion of the contribution or benefits determined on the differential wage payments will satisfy nondiscrimination, so long as the payment and the ability to make contributions based on such payment are provided on reasonably equivalent terms. This applies to all the following IRC sections:

- Nondiscrimination of benefits and contributions under IRC §401(a)(4);
- The ADP testing or safe harbor rules under IRC §401(k)(3), (11) and (12);
- The ACP testing or safe harbor rules under IRC §401(m);
- The nondiscrimination rules for 403(b) plans under IRC §403(b)(12);
- The SEP rules under IRC §408(k)(3) and (6);
- The SIMPLE rules under IRC §408(p);
- The coverage rules under IRC §410(b); and
- The top-heavy rules under IRC §416.

Therefore, benefits or contributions based on differential wage payments need not be included in the plan's nondiscrimination testing.[61]

NONSAFE HARBOR DEFINITIONS OF IRC §414(S) COMPENSATION

If IRC §415 compensation is modified in any manner other than by the safe harbor modifications described above, the resulting compensation may be treated as IRC §414(s) compensation only if:

- the definition is reasonable, and
- satisfies a compensation ratio test (defined below).

If the compensation does not meet these two requirements, it is not an IRC §414(s) definition of compensation—that is, it is not nondiscriminatory. This means it may not be used for purposes of

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[60] Treas. Reg. §1.414(s)-1(c)(5).
[61] IRC §414(u)(12)(A).

applying the nondiscrimination tests to employer-provided contributions and benefits, elective deferrals, permitted disparity formulas, matching contributions and after-tax employee contributions. The plan may still use this definition of compensation for the allocation of contributions or the determination of benefits, but the resulting contributions or benefits must be tested for nondiscrimination using the general test under IRC §401(a)(4) using compensation that does meet the requirements of IRC §414(s).

EXAMPLE 4-12. Effect of Nonsafe Harbor Compensation on Safe Harbor Allocation Formula. A plan allocates a profit-sharing contribution pro rata based on a definition of compensation that excludes bonuses and overtime. The compensation definition does not pass the compensation ratio test (defined below). Despite the fact that a pro rata allocation of contribution is normally a safe harbor allocation for purposes of general nondiscrimination in IRC §401(a)(4), this allocation must be tested for nondiscrimination under the general test, using an acceptable IRC §414(s) definition of compensation, such as total compensation or another definition that meets the compensation ratio test.

Suppose that every participant received a profit-sharing allocation equal to 10 percent of compensation excluding bonuses and overtime.

	Total Compensation	Allocation Compensation	Contribution Allocation	Allocation as % of Total Compensation
HCE-1	$200,000	$150,000	$15,000	7.5%
NHCE-1	$50,000	$40,000	$4,000	8%
NHCE-2	$40,000	$35,000	$3,500	8.75%
NHCE-3	$30,000	$15,000	$1,500	5%
NHCE-4	$25,000	$25,000	$2,500	10%

When the above contribution allocation for each participant is divided by total compensation (i.e., compensation before removal of bonuses and overtime), the rate of allocation is no longer a level percentage. Therefore, it is not a safe harbor allocation for nondiscrimination purposes and is subject to the general test under IRC §401(a)(4), using an IRC §414(s) definition of compensation to show that the resulting allocation is not discriminatory.

Reasonable Definition

The modification must refer to a category or classification of compensation that is applied on a consistent basis to all employees.[62] The regulation provides that a modification that excludes bonuses, overtime, premiums for shift differential or call-in premiums is automatically considered

[62] Treas. Reg. §1.414(s)-1(d)(2)(i).

to be a **reasonable definition**.[63] The definition may not simply disregard a percentage of an employee's compensation.[64] For example, IRC §414(s) compensation may not be defined as 90 percent of the employee's IRC §415 compensation.

Compensation Ratio Test

The compensation ratio test looks at the percentage of each employee's total compensation that is included in the modified definition. Total compensation means IRC §415 compensation (either including or excluding elective deferrals). The compensation ratio test is satisfied if the HCE compensation percentage is not more than a *de minimis* amount greater than the NHCE compensation percentage. [65] Whether a difference is *de minimis* depends on facts and circumstances. The IRS generally views the *de minimis* standard very narrowly. Some IRS personnel have indicated that they will use a 3 percent or smaller spread as a de minimis standard, but emphasize that no particular percentage is considered by the IRS as a safe harbor.

Individual compensation percentages are calculated for each employee by dividing the employee's compensation—as determined under the modified definition—by the employee's total compensation as it would be determined under a safe harbor definition of compensation.[66] For example, suppose an employee's total compensation is $50,000, $5,000 of which is a year-end bonus. If the modified definition excludes bonuses, the employee's modified compensation is $45,000. The employee's compensation percentage is $45,000/$50,000, or 90 percent.

Once the individual compensation percentages are determined, the percentages of the HCEs are averaged to determine the HCE compensation percentage, and the percentages of the NHCEs are averaged to determine the NHCE compensation percentage.[67]

A different method may be used to calculate the compensation percentages, but only if the method used cannot reasonably be expected to create a significant variance from the individual percentage method. For example, it may be reasonable to calculate the compensation percentage for a group of employees (i.e., NHCEs or HCEs) by dividing the aggregated modified compensation of all employees in the group by the aggregated total compensation of the employees in the group.[68]

EXAMPLE 4-13. Employer Contribution Allocation. A profit-sharing plan allocates employer contributions under a pro rata formula based on compensation. The compensation definition excludes bonuses. The table below shows the compensation ratio test calculation. The percentage in column (5) is determined by dividing the amount in column (4) by the amount in column (2), except in the case of HCE-1. For HCE-1, the compensation percentage in column (5) is 100 percent, because the amounts in columns (2) and (4) must be limited to the dollar limit in effect under IRC §401(a)(17) (i.e., $285,000 in 2020).

[63] Treas. Reg. §1.414(s)-1(d)(2)(ii).
[64] Treas. Reg. §1.414(s)-1(d)(iii).
[65] Treas. Reg. §1.414(s)-1(d)(3).
[66] Treas. Reg. §1.414(s)-1(A)(3).
[67] Treas. Reg. §1.414(s)-1(d)(3)(iv)(A).
[68] Treas. Reg. §1.414(s)-1(d)(3)(iv).

(1) Employee	(2) Total Compensation	(3) Bonus	(4) Contribution (Less Bonus)	(5) Compensation Percentage
HCEs				
HCE-1	$330,000	$20,000	$310,000	100%
HCE-2	$100,000	$10,000	$90,000	90%
HCE-3	$80,000	$4,000	$76,000	95%
NHCEs				
NHCE-A	$50,000	$4,000	$46,000	92%
NHCE-B	$45,000	$6,000	$39,000	86.67%
NHCE-C	$35,000	$0	$35,000	100%
NHCE-D	$30,000	$0	$30,000	100%
NHCE-E	$25,000	$0	$25,000	100%

Determining the compensation ratios for each group. The NHCE compensation ratio is determined by adding the individual compensation percentages of the NHCEs in column (5) and dividing by the number of NHCEs (i.e., 5): (92% + 86.67% + 100% + 100% + 100%)/5 = 95.73%. The HCE compensation ratio is determined by adding the individual compensation percentages of the HCEs in column (5) and dividing by the number of HCEs (i.e., 3): (100% + 90% + 95%)/3 = 95%. The compensation ratio test is satisfied because the NHCE compensation ratio is greater than the HCE compensation ratio. If the HCE compensation ratio was the greater percentage, the test would be satisfied only if the difference in favor of the HCE compensation percentage was not more than a de minimis amount.

The compensation ratio test encompasses the employees who are included in the applicable nondiscrimination test. For example, if the modified definition is being used to show that employer contributions to a profit-sharing plan satisfy the nondiscrimination requirements of IRC §401(a)(4), only the employees who share in the allocation of the employer contributions made for that plan year are included in the compensation ratio test. Employees who are self-employed are not included in the compensation ratio test. See below for an adjustment that must be made to the earned income of the self-employed individuals to satisfy IRC §414(s).

When determining an employee's compensation percentage, both the numerator and the denominator are limited by the dollar cap prescribed by IRC §401(a)(17).

EXAMPLE 4-14. Application of Dollar Cap to Compensation Ratio Test. In the prior example, the compensation percentage for HCE-1 was 100 percent, even though HCE-1 was paid a bonus of $20,000. Why is that? Assume that the IRC §401(a)(17) compensation limit is $285,000. If HCE-1's bonus is subtracted from

HCE-1's total compensation in column (2), the net amount is $310,000, which exceeds the applicable dollar limit. Furthermore, HCE-1's total compensation (that is, the denominator of the compensation percentage) is limited to the compensation limit. Therefore, HCE-1's compensation ratio is $285,000/$285,000, or 100 percent.

Employee Who is an Eligible Participant for Only Part of Year

The nondiscrimination testing rules permit the compensation of an employee to be measured for just that part of the plan year that he or she is an eligible employee.[69] Presumably, then, to demonstrate whether a modified definition of compensation satisfies IRC §414(s), the compensation ratio of an employee described in this paragraph may be determined by dividing modified compensation for the portion of the year that the employee is eligible by the total compensation for the same portion of the year.

EXAMPLE 4-15. Midyear Entry Date. An employee becomes eligible for a plan on July 1. The plan year ends December 31. Therefore, the employee is eligible for only the last six months of the plan year in which the employee first becomes eligible. The plan excludes bonuses from the definition of compensation. The employee's compensation ratio may be determined as compensation (excluding bonuses) for the period July 1 through December 31, divided by total compensation for the employee for the same period. The employee's total compensation would include any bonuses paid during the six-month period in which the employee was eligible for the plan year. If a bonus was paid in June, it would not be included in the employee's total compensation reflected, neither in the numerator nor in the denominator of the employee's compensation ratio.

EXAMPLE 4-16. Employment Exclusion. A plan excludes union employees. For the plan year ending December 31, M becomes part of a collective-bargaining unit and is excluded from the plan as of July 1. Therefore, M is eligible for the plan only for the period January 1 through June 30, and M's active participation in the plan ends thereafter. The plan excludes overtime from the definition of compensation. M's compensation ratio may be determined as M's compensation (excluding overtime) for the period January 1 through June 30, divided by M's total compensation for the same period. M's total compensation for the plan year includes any overtime paid in the six-month period during which M is eligible.

[69] Treas. Reg. §1.401(a)(4)-12, definition of plan year compensation, Treas. Reg. §1.401(k)-6, definition of compensation.

EARNED INCOME DEFINITION USED FOR SELF-EMPLOYED INDIVIDUALS

IRC §414(s) compensation for a self-employed individual means earned income as defined in IRC §401(c)(2). Earned income may be modified to include elective deferrals or to exclude a certain type of compensation for HCEs only. For example, if IRC §414(s) compensation for the common law employees is defined as IRC §415 compensation—which includes elective deferrals—the earned income of the self-employed individuals also must be "grossed up" for the same types of deferrals in accordance with the IRC §415 definition.[70] If IRC §414(s) compensation for common law employees is adjusted by the safe harbor modification relating to fringe benefits or by any other modification described above, then an adjustment is required to determine the self-employed individual's IRC §414(s) compensation. The adjustment is the same percentage as the NHCE compensation percentage under the modified compensation definition.[71] For example, if the NHCE compensation percentage is 90 percent, then each self-employed individual's earned income must be multiplied by 90 percent to arrive at his or her IRC §414(s) compensation.

RATE-OF-PAY DEFINITION

IRC §414(s) compensation may be defined as an employee's basic rate or regular rate of compensation, rather than the employee's actual compensation.[72] This "rate-of-pay" definition also may be based on the rate of compensation plus actual amounts of irregular or additional compensation, such as bonuses. The plan cannot use a rate-of-pay definition to test whether benefits or contributions are nondiscriminatory unless it uses the same definition to determine contribution allocations. Because the rate-of-pay definition is not a safe harbor, the compensation taken into account must satisfy the compensation ratio test to be treated as IRC §414(s) compensation. The adjustment applicable to self-employed individuals also would apply if the plan uses a rate-of-pay definition to determine IRC §414(s) compensation for common law employees.

The rate-of-pay definition may not be used to apply the nondiscrimination tests under IRC §401(k)(3) (ADP test) and IRC §401(m)(2) (ACP test).

RELATED EMPLOYERS

Related employers under the controlled group and affiliated service group rules of IRC §§414(b), (c) and (m) are aggregated for nondiscrimination testing purposes. Therefore, an employee's IRC §414(s) compensation includes his or her compensation from all related employers, regardless of whether the employers maintain a single plan or separate plans. This is the same principle discussed earlier for the IRC §415 compensation definition. Note, however, that for nondiscrimination testing purposes, the plan might disregard compensation from a related employer if the compensation ratio test can be satisfied under the modified definition of compensation.

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[70] Treas. Reg. §1.414(s)-1(g)(1)(ii).
[71] Treas. Reg. §1.414(s)-1(g).
[72] Treas. Reg. §1.414(s)-1(e).

4.06: Plan's Definition of Compensation for Allocation 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 might also affect how much an employee may defer each year under the 401(k) arrangement (e.g., if elective deferrals are limited to 15 percent of compensation), or the level of 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 allocation purposes may be IRC §415 compensation, IRC §414(s) compensation or a compensation definition that does not satisfy either definition.

Remember two additional rules:

1. 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; and
2. When determining an employee's compensation for allocation purposes, the compensation is limited by the dollar cap prescribed by IRC §401(a)(17).

As noted above, compensation for allocation purposes may or may not include differential wage payments.[73]

NONDISCRIMINATION TESTING SAFE HARBORS

If the plan is intended to be a design-based safe harbor under the IRC §401(a)(4) regulations with respect to the allocation of employer contributions (other than matching contributions) under a defined contribution plan, then the definition used for allocation purposes must satisfy one of the permitted definitions of IRC §414(s) compensation.[74] 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 allocation purposes. When the plan is tested for nondiscrimination, the allocation 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 allocated to the employee for that year. (See Example 4-12 above.)

SAFE HARBOR CONTRIBUTIONS UNDER A SAFE HARBOR 401(K) PLAN

If a 401(k) plan is intended to be a safe harbor 401(k) plan as described in IRC §401(k)(12) or (13), the definition of compensation that is used to determine the safe harbor matching contribution or safe harbor nonelective contribution must satisfy the IRC §414(s) compensation definition.[75]

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[73] Notice 2010-15, IRB 2010-6 (1/20/10), Q&A-10.
[74] Treas. Reg. §1.401(a)(4)-12, *plan year compensation* definition.
[75] Treas. Reg. §1.401(k)-3(b)(2).

TREATMENT OF SEVERANCE PAYMENTS FOR ALLOCATION PURPOSES

A question often arises about the proper treatment of severance payments under the plan. Sometimes the plan document will specifically exclude or specifically include severance payments in determining an employee's allocation. But sometimes the document is not so clear. When the document is ambiguous, the plan administrator may need to interpret the document to determine what the definition of compensation is for allocation purposes. However, keep in mind the severance rules for IRC §415 purposes, as described below.

As discussed earlier in this chapter, regulations under IRC §415 indicate that severance compensation generally is not includible in IRC §415 compensation. However, payments are included in IRC §415 compensation if:

1. the payment is actually made by the later of:
   D. 2 ½ months after severance from employment, or
   E. the last day of the limitation year in which the severance occurs, and
2. the amounts would have been included in IRC §415 compensation if they were paid prior to the employee's severance from employment[76] and fall into one of the following categories:

- Payments—regular compensation, bonuses, commissions, overtime, etc.— the employee would have received had he or she continued employment; or
- Payments for unused sick leave, vacation time, etc. that the employee could have used if employment had continued.[77]

Accordingly, true severance pay that is not given to an employee except on termination of employment, nonqualified deferred compensation and parachute payments received after employment termination are never compensation for IRC §415 compensation purposes.

It is the IRS' position that elective deferrals under a 401(k) arrangement may not be made from severance pay because the individual receiving severance pay is no longer an employee.[78]

SPECIAL RULES OR PRE-APPROVED PLANS

A pre-approved plan must offer an option to elect safe harbor definitions of IRC §414(s) compensation for these purposes.[79] In other words, a pre-approved plan must provide for at least one definition that does not require testing under Treas. Reg. §1.414(s)-1(d).

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[76] Treas. Reg. §1.415(c)-2(e)(3)(i). Condition (1) is often referred to as the 2½-month rule, even though payments may be made more than 2½ months after severance if made by the end of the limitation year in which the severance occurs.
[77] Treas. Reg. §1.415(c)-2(e)(3).
[78] Treas. Reg. §§1.401(k)-1(e)(8), 1.415(c)-2(e)(3).
[79] Rev. Proc. 2011-49, §5.03.

COMPENSATION FOR DETERMINING TOP-HEAVY PLANS MINIMUM ALLOCATIONS

If a plan is top-heavy, it must guarantee the non-key employees a minimum allocation. Compensation used to calculate the required minimum allocation must be IRC §415 compensation.[80] The plan may not use a lesser definition of compensation to determine the minimum allocation. 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 allocation under the top-heavy rules. In addition, it is important to remember that compensation under IRC §415 is based on the full plan year, regardless of whether the participant entered the plan mid-year.

4.07: Employer Deductions

Compensation may directly or indirectly affect an employer's deduction for qualified plan contributions. If the employer contributes to a profit-sharing plan, stock bonus plan or a money purchase pension plan, the deduction limit is based on a percentage of aggregate compensation paid to all participants. The percentage is generally 25 percent of compensation. Compensation for this purpose is defined in Treas. Reg. §1.404(a)-9(b)(2).

The definition of compensation for purposes of the deduction limits includes elective deferrals that are taken into account under IRC §415(c)(3)(D), as well as deemed compensation for certain disabled participants, as described in IRC §415(c)(3)(C). This makes the definition of compensation used for deduction purposes essentially the same as the definition used for IRC §415 purposes. Note, however, that compensation for deduction purposes is measured on the basis of the employer's taxable year, whereas compensation for IRC §415 purposes is measured on the basis of the limitation year, which may be different from the employer's taxable year. Also note that Treas. Reg. §1.404(a)-9(b)(2) refers to compensation paid or accrued, whereas IRC §415 compensation is generally determined on a cash basis, subject to the first few weeks rule described in Treas. Reg. §1.415-2(d)(5)(ii) (discussed above).[81]

The definition of compensation used by a plan for allocation purposes is irrelevant in determining compensation for deduction purposes. For example, if a profit-sharing plan excluded bonuses to determine a participant's share of employer contributions, the bonuses are still included in compensation to calculate the employer's deduction limit.

Because differential wage payments are considered to be compensation, these payments should be included in the amount of compensation for purposes of determining the 25 percent limitation described above.

There is some controversy as to which participants are includable in the determination of the 25 percent deductible limit; in particular, are participants who are eligible to defer but not eligible to

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[80] IRC §416(c); Treas. Reg. §1.416-1, T-21.
[81] IRC §414(u)(12)(A)(ii).

receive an employer match or profit-sharing contribution included? Historically, the answer was "yes," but the IRS has privately ruled that the Pension Protection Act of 2006 (PPA)[82] changed that. Because deferrals are separately deductible under PPA, it appears that only those eligible to receive an employer contribution should be included in the 25 percent deduction limitation calculation.

DETERMINING 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.

Short Taxable Year

In the case of a short taxable year, the IRC §404(a)(3) deduction limit (i.e., the 25 percent of compensation limit for profit-sharing plans) is applied to aggregate participant compensation paid for the short period. In addition, the short taxable year will cause the applicable compensation dollar limit under IRC §401(a)(17) to be prorated.[83]

EXAMPLE 4-17. Taxable Year and Plan Year Both Amended. Corporation X maintains a profit-sharing plan. Effective January 1, 2020, 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, 2019. 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 4-18. Taxable Year Changed but Plan Year Not Amended. Suppose the plan year is not amended in the prior example. On March 1, 2020, X makes a $75,000 contribution for the short taxable year. The contribution is allocated for the plan year ending June 30, 2019 (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, 2019, it has to be allocated, in accordance with Rev. Rul. 76-28, in the same manner as a contribution made on December 31, 2019, would be allocated. Allocation of a December 31, 2019, contribution for the plan year ending June 30, 2020, 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, 2019, through June 30, 2020. The fact that the deduction for the contribution is

[82] PLR 201229012.
[83] Treas. Reg. §1.401(a)(17)-1(b)(3)(iii).

based on compensation for the six-month taxable year does not affect the allocation of the contribution for the 12-month plan year.

Short Plan Year

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 4-16, 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 4-19. Employer Deduction and 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, 2020, the plan year is amended to the calendar year. There is a short plan year from October 1 to December 31, 2019. For Corporation W's taxable year ending September 30, 2020, 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, 2020, and deducts the contribution for the taxable year ending September 30, 2020. Corporation W designates $35,000 of that contribution for the short plan year ending December 31, 2019, and the rest for the 2020 plan year. This is an acceptable treatment of the contribution. The fact the deduction is taken for the taxable year ending September 30, 2020, 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, 2019). The remainder of the contribution will be allocated for the 2020 year based on compensation for that calendar year.

Additional contributions could be made for the 2020 plan year and deducted for Corporation W's taxable year ending September 30, 2020. 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.

DEDUCTION LIMITS AND OVERLAPPING DB/DC PLANS

If the employer maintains certain "overlapping plans," an overall deduction limit may apply 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. Note that the term "overlapping" is not a term referenced in the law or regulations, but is being used to simplify the concept presented on deduction limits.

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 deferrals under a 401(k) arrangement, the IRC §404(a)(7) limit does not apply. Additionally, defined benefit plans that are covered by the PBGC are disregarded for purposes of applying IRC §404(a)(7).[84]

The overall deduction limit under IRC §404(a)(7) for contributions to the overlapping plans is the greater of:

- 25 percent of the aggregate compensation of all participants under the overlapping plans, or
- the minimum funding requirement for the defined benefit plan.

EXAMPLE 4-20. 6 Percent Cushion Not Exceeded. The aggregate compensation of all participants in a 401(k) plan is $1,000,000. The total employer contribution to the 401(k) plan is $170,000: (1)

$120,000 attributable to elective deferrals under the 401(k) arrangement, and (2) $50,000 of matching contributions. The employer also maintains a DB plan that covers the same participants as in the 401(k) plan, and makes a contribution to the DB plan for the year equal to the minimum funding requirement of $220,000. In this case, the IRC §404(a)(7) limit is the greater of (a) $250,000 (i.e., 25 percent of aggregate participant compensation of $1,000,000) or (b) the minimum funding requirement in the DB plan ($220,000). Because the minimum funding requirement in the DB plan is not greater than the 25 percent limit under IRC §404(a)(7)(A), the maximum deductible amount is $250,000.

However, profit-sharing contributions that are less than 6 percent of compensation are not subject to the IRC §404(a)(7) limitation. Six percent of the applicable total compensation is $60,000 ($1,000,000 x 6%). The amount of the employer contribution to the DC plan that is potentially subject to the IRC §404(a)(7) deduction limit is the total contribution ($170,000), less elective deferrals ($120,000), or $50,000. However, because this amount is less than 6 percent of compensation ($60,000), it is not subject to the limitation. Therefore, the employer's entire contribution to the 401(k) plan is fully deductible.

If the profit-sharing contribution (not including deferrals) was $70,000, the portion in excess of 6 percent of compensation, $10,000, would be subject to the IRC §404(a)(7) limitation. The total contribution subject to the limit would be the DB contribution of $220,000, plus the applicable portion of the profit-sharing contribution ($10,000), for a total of $230,000. Because the IRC §404(a)(7) limit was $250,000, all contributions are deductible.

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[84] IRC §404(a)(7)(C)(iv).

Application of IRC §404(a)(7) if DC Contributions Do Not Exceed the 6 Percent Cushion

Does IRC §404(a)(7) apply to the DB plan if the employer contributions to the DC plan are disregarded in their entirety by reason of the 6 percent cushion? Suppose, for example, the minimum funding requirement for the DB plan and the IRC §401(a)(7) limit were both $100,000, but the maximum deductible limit for the DB plan (without regard to IRC §401(a)(7)) was $175,000. If the DC contribution does not exceed the 6 percent cushion, would the DB contribution nonetheless remain subject to the $100,000 limit under IRC §404(a)(7)?

The answer to this question is "no." If the 6 percent cushion is not exceeded in the DC plans otherwise taken into account, then the IRC §404(a)(7) does not apply to the DB plan. Thus, the deduction limit for contributions to the DB plan can be determined solely on the basis of the maximum deduction limit for such plans.

Interaction Between 6 Percent Cushion and the Deduction Limitation for DC Plans

Suppose an employer maintains a defined benefit plan and a profit-sharing plan. The same employees participate in both plans. The aggregate compensation of the employees is $1,000,000. The minimum funding requirement for the defined benefit plan is only 5 percent of this aggregate compensation, or $50,000. This leaves 20 percent of the 25 percent of compensation deduction limit available to the DC plan. Because the DC contribution up to 6 percent of compensation is not counted towards the IRC §404(a)(7) limit, it might appear that our total deductible amount to the DC plan could be 26 percent of compensation (i.e., 6 percent that is not subject to the limit, plus the 20 percent available under the limit). Nonetheless, the employer may not contribute and deduct 26 percent of compensation to the profit-sharing plan. Profit-sharing plans are subject to a 25 percent of compensation deduction limit, notwithstanding the IRC §404(a) combined plan limit, and the profit-sharing limit includes all contributions (including amounts below 6 percent of compensation).[85] Therefore, the maximum deduction to the profit-sharing plan is 25 percent of compensation.

4.08: Review of Key Concepts

- When must a plan use IRC §415 compensation?
- What are the permissible definitions of IRC §415 compensation?
- Describe the differences among the definitions of IRC §415 compensation.
- What is IRC §414(s) compensation and when is it used?
- Describe the safe harbor modifications to IRC §415 compensation that will satisfy the IRC §414(s) definition of compensation.
- What tests are necessary to show that a definition of compensation is nondiscriminatory?
- Describe how a plan's definition of compensation for allocation purposes may or may not differ from IRC §415 and IRC §414(s) definitions of compensation.

[85] IRC §404(a)(3).

- Calculate the compensation nondiscrimination test.
- Describe how a short taxable year or a short plan year affects the computation of the employer's deduction.
- What is the employer deduction for an employer maintaining overlapping defined contribution and defined benefit plans?

4.09: For Practice – True or False

A. IRC §415 compensation must include elective deferrals to a 401(k) plan.
B. The average percentage of total compensation that is considered for NHCEs must be at least 70 percent of the average percentage of total compensation considered for HCEs in order for the definition of compensation to satisfy IRC §414(s).
C. The plan's definition of compensation used for allocating contributions must satisfy the nondiscriminatory definition of compensation under IRC §414(s).
D. IRC §414(s) compensation must include elective deferrals to a 401(k) plan to avoid testing that definition for nondiscrimination.
E. IRC §415 compensation must be used to determine HCEs.
F. IRC §414(s) compensation must be used to determine key employees.
G. IRC §415 compensation must not include tips, depending on how IRC §415 compensation is defined.
H. Designated Roth contributions are included in IRC §415 compensation.
I. Excluding nontaxable fringe benefits from IRC §415 compensation is a safe harbor modification to IRC §414(s) compensation, meaning the resulting definition will not need to be tested for nondiscrimination purposes.
J. IRC §415 compensation is based on the plan year.

4.10: Sample Test Questions

1. All of the following statements regarding IRC §414(s) compensation are TRUE, EXCEPT:

A. A plan using a safe harbor definition of IRC §414(s) compensation for nondiscrimination testing need not perform the compensation ratio test.
B. A plan using a nonsafe harbor definition of IRC §414(s) compensation for nondiscrimination testing must apply such definition consistently for all participants.
C. A plan may meet the safe harbor definition of IRC §414(s) compensation by including 401(k) elective deferrals and excluding 125 plan elective deferrals.
D. A plan may use a 12-month period other than the plan year for purposes of determining IRC §414(s) compensation.
E. A plan may use a rate-of-pay definition of compensation for IRC §414(s) purposes.

2. All of the following exclusions are deemed reasonable for defining IRC §414(s) compensation, EXCEPT:

A. 20 percent of regular compensation
B. Bonuses
C. Overtime

D. Expense allowances
E. Fringe benefits

3. All of the following are included in compensation under IRC §415, EXCEPT:

F. Elective deferral
G. Expense reimbursements paid under an accountable plan
H. Bonuses
I. Overtime
J. Commissions

4. Based on the following information, determine the participant's IRC §415 compensation:

- The employer sponsors a 401(k) plan that allows designated Roth contributions.
- The plan excludes overtime for allocation purposes.
- The participant's taxable income, not including elective deferrals, is $58,000.
- The participant defers $4,000 as pre-tax elective deferrals and $4,000 as designated Roth contributions.
- The participant defers $500 into the employer's IRC §125 plan.
- The participant's overtime compensation totals $3,000.

A. $58,000
B. $59,500
C. $62,500
D. $66,500
E. $69,500

5. Which of the following statements regarding the calculation of the employer deduction is/are TRUE?

I. In the case of a short taxable year, the deduction limit for a defined contribution plan is applied to aggregate participant compensation paid for the short period.

II. A short taxable year results in a prorated compensation dollar limit under IRC §401(a)(17).

III. A short plan year does not directly affect the defined contribution deduction limit because that deduction limit is based on participant compensation for the employer's taxable year.

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

6. Based on the following information, which of the following statements regarding the compensation ratio is/are TRUE?

Participant	Total Compensation	Bonus	Compensation Less Bonus	Compensation Percentage
HCE 1	$200,000	$40,000	$160,000	80%
HCE 2	$180,000	$30,000	$150,000	83%
NHCE 1	$100,000	$20,000	$80,000	80%
NHCE 2	$75,000	$0	$75,000	100%
NHCE 3	$50,000	$0	$50,000	100%

I. The plan passes the compensation ratio test.
II. The compensation ratio for the HCEs is 81.5%.
III. The compensation ratio for the NHCEs is 93.3%.

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

7. Which of the following describe when a plan's definition of compensation is subject to nondiscrimination testing, EXCEPT:

A. The plan defines IRC §414(s) compensation as IRC §415 compensation excluding elective deferrals to a cafeteria plan and including elective deferrals to a 401(k) plan.
B. The plan defines IRC §414(s) compensation as IRC §415 compensation excluding commissions for HCEs only.
C. The plan defines IRC §414(s) compensation as IRC §415 compensation excluding overtime.
D. The plan defines IRC §414(s) compensation as IRC §415 compensation excluding bonuses.
E. The plan defines IRC §414(s) compensation as IRC §415 compensation excluding commissions.

8. Based on the following information, determine the combined plan deduction:

- The employer sponsors a profit-sharing and a defined benefit plan.
- The defined benefit plan is not covered by the PBGC.
- The employer makes a contribution to the defined benefit plan in the amount of $250,000 which meets the minimum funding requirements.
- The employer makes a contribution to the profit-sharing plan of $30,000.
- Compensation for all eligible employees is $600,000.

A. $30,000
B. $36,000

C. $150,000
D. $250,000
E. $280,000

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

4.11: Solutions to True or False Questions

1. True.
2. False. If the definition of compensation does not satisfy one of the IRC §414(s) safe harbors, the average percentage of total compensation that is considered for HCEs cannot exceed the average percentage of total compensation for NHCEs by more than a de minimis amount.
3. False. IRC §414(s) compensation must be used to determine if the contributions are nondiscriminatory. However, a plan is not required to use a definition of compensation that satisfies IRC §414(s) in calculating the amount of contributions provided in the plan.
4. False. Elective deferrals may be excluded from the definition of IRC §414(s) compensation as a safe harbor, so long as all elective deferrals (i.e., 401(k), 403(b), Roth, and 125 Plan) are treated the same.
5. True.
6. False. IRC §415 compensation must be used to determine key employees.
7. False. IRC §415 compensation may include some tips
8. True. Care must be taken that designated Roth contributions are not counted twice, due to how these contributions are reported on Form W-2.
9. False. None of the definitions include nontaxable fringes. They only include taxable fringe benefits.
10. False. IRC §415 compensation is based on a limitation year, which may or may not be the same as the plan year.

4.12: Solutions to Sample Test Questions

1. The answer is **C**. The treatment of deferrals (including those for 401(k) and 125 plans) must be consistent, either all included or all excluded, for the definition to meet the safe harbor requirements.
2. The answer is **A**. Percentages of compensation are not deemed reasonable exclusions for IRC §414(s) purposes.
3. The answer is **B**. Expense reimbursements paid under an accountable plan are excluded form IRC §415 compensation.
4. The answer is **C**. The participant's taxable income of $58,000 plus 401(k) elective deferrals of $4,000 and 125 plan elective deferrals of $500 equals $62,500. The designated Roth contributions would already be included in the $58,000 reported on the W-2.
5. The answer is **E**. The definition of compensation used by a plan for allocation purposes is irrelevant in determining compensation for deduction purposes. For example, even if a profit-sharing plan excluded bonuses to determine a participant's share of employer contributions, the bonuses are still included in compensation to calculate the employer's deduction limit.
6. The answer is **E**. The NHCE's compensation ratio is higher than the HCE's compensation ratio, therefore the plan passes the compensation ratio test. The HCE's ratio is 81.5% ((80+83)/2) and the NHCE's ratio is 93.9% ((80+100+100)/3).

7. The answer is **B**. A plan may use IRC §415 compensation and exclude an item of compensation that applies only to HCEs when it defines compensation for IRC §414(s) nondiscrimination purposes.
8. The answer is **E**. An employer who sponsors a defined benefit plan, not covered by the PBGC, and a defined contribution plan is subject to the combined plan limit if the amount contributed to the defined contribution plan is more than 6% of aggregate compensation. In this question, the amount contributed to the defined contribution plan is less than 6% ($600,000 *.06 = $36,000) thus the combined plan limit does not apply. The deduction amount is $280,000 ($250,000 for the defined benefit plan + $30,000 for the profit-sharing plan.)

CHAPTER 5:

AVERAGE BENEFIT TEST AND SPECIAL RULES

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5.01: Key Terms

- Allocation rate
- Average benefit test
- Average benefit percentage test
- Average benefit percentage testing group
- Benefit rate
- Benefiting employee
- Employee benefit percentage
- Facts and circumstances test
- Fail-safe language
- HCE actual benefit percentage
- Mandatory disaggregation
- NHCE actual benefit percentage
- NHCE concentration percentage
- Nondiscriminatory classification test
- Nonexcludable employees
- Otherwise excludable employee
- Permissive aggregation
- Reasonable classification
- Safe harbor percentage
- Snapshot testing
- Statutory employee
- Substantiation quality data

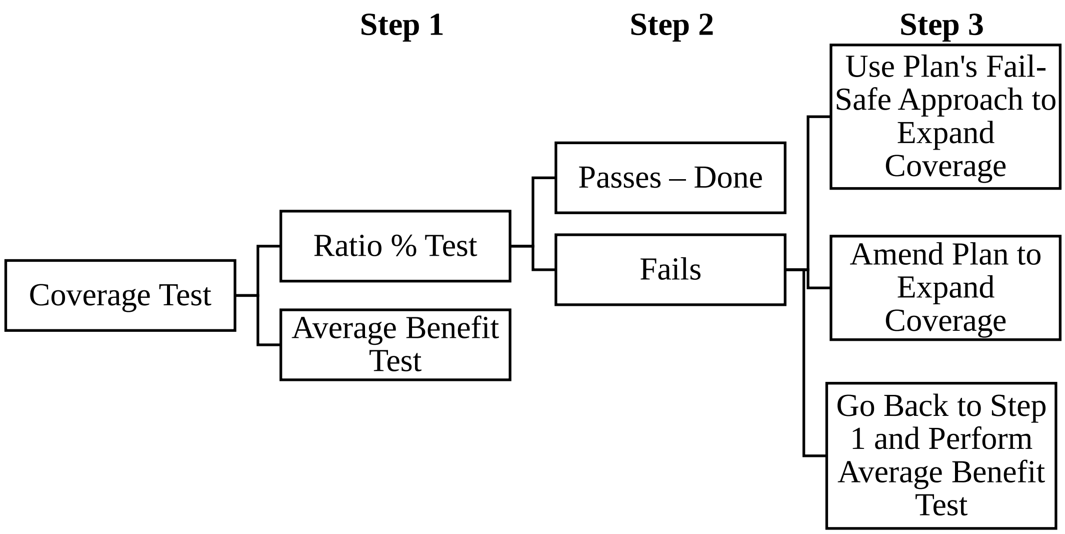
5.02: Introduction

In the QKA courses, we discussed the coverage requirements under IRC §410(b). The crux of these requirements is that a plan must pass one of two numeric tests: the **ratio percentage test** or the **average benefit test**. In that chapter, we outlined the rules for the ratio percentage test in detail. Here, we will discuss the more complex average benefit test.

Because the average benefit test is more complex and requires the collection of more data, it is usually used only when the ratio percentage test fails. At that point, the company has two choices:

1. Expand coverage to pass the ratio percentage test (using the plan's fail-safe approach specified in the plan document, or, if there is no fail-safe language in the plan document, amend the plan to expand coverage); or

2. Perform and pass the average benefit test.



This chapter begins with a discussion of the mechanics of performing the average benefit test. Next, there is an explanation of some of the special rules that may apply to the average benefit test, such as permissive aggregation, mandatory disaggregation, mergers and acquisitions, QSLOBs and leased employees. The chapter ends with a discussion of corrections that may be implemented if the plan does not satisfy the coverage requirements.

5.03: Performing the Average Benefit 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**. Both of these parts of the test must be satisfied for the plan to pass the average benefit test.

In general, the group of employees to include in testing, called the average benefit percentage (ABP) testing group (or coverage testing group), is the same as those employees used in the ratio percentage test, all employees of the employer and related companies, but excluding:

- Nonresident aliens;
- Union employees;
- Individuals who do not meet the plan's age and service requirements; and
- Employees who terminated during the plan year with 500 or fewer hours of service (assuming that this prevents them from participating in the plan).

The employees in the ABP testing group are also called nonexcludable employees because they cannot be excluded from coverage testing.

NONDISCRIMINATORY CLASSIFICATION TEST

The plan passes the nondiscriminatory classification test if the classification of employees who benefit under the plan is both reasonable and nondiscriminatory.

REASONABLE CLASSIFICATION

The classification of employees who benefit under the plan is considered a reasonable classification if it is established under objective business criteria that identify the category of employees covered by the plan. Reasonable classifications include:

- Specified job categories (e.g., secretaries);
- Nature of compensation (hourly or salaried); or
- Geographic location.

Naming individual employees as eligible or ineligible is not a reasonable classification for this purpose.[1]

Note that the reference to naming individuals is found only in the section of the regulations pertaining to the reasonable classification requirement of the average benefit test. This implies that naming an individual as an excluded employee is permissible for coverage testing purposes so long as the plan passes the ratio percentage test because the reasonable classification requirement is not applicable when the plan passes the ratio percentage test. The Internal Revenue Service (IRS) appears to agree indirectly with this interpretation.[2]

Nondiscriminatory Classification

The classification is nondiscriminatory if the plan's coverage ratio satisfies either the safe harbor percentage test or the facts and circumstances test. The coverage ratio is calculated in exactly the same way as it is calculated under the ratio percentage test—the percentage of benefiting nonhighly compensated employees (NHCEs) divided by the percentage of benefiting highly compensated employees (HCEs).

Safe Harbor Percentage Test

The coverage ratio must be at least equal to the safe harbor percentage defined in the regulations.[3]The table of safe harbor percentages is reproduced in the Appendix of this chapter. The safe harbor percentage applicable to the plan depends on the percentage of the ABP testing group that is composed of NHCEs, known as the NHCE concentration percentage. The highest safe harbor percentage is 50 percent. So, if the coverage ratio is at least 50 percent, you know this test is satisfied without looking at the table.

Facts and Circumstances Test

The coverage ratio must be greater than or equal to the unsafe harbor percentage (see the Appendix to this chapter for the table of unsafe harbor percentages), and the classification must be nondiscriminatory under the facts and circumstances. The unsafe harbor percentage for the plan is based on the NHCE concentration percentage.

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[1] Treas. Reg. §1.410(b)-4(b).
[2] 2001 Q&A Session by the Joint Committee on Employee Benefits of the American Bar Association (www.abanet.org).
[3] Treas. Reg. §1.410(b)-4(c)(2).

Relevant factors in making the facts and circumstances determination as to whether the classification is nondiscriminatory include:

- The underlying business reason of the classification;
- The percentage of all employees benefiting from the plan;
- Whether the number of benefiting employees in each salary range is representative of the total number of employees in that salary range;
- The difference between the plan's coverage ratio and the safe harbor percentage; and
- The degree by which the plan's average benefit ratio exceeds 70 percent.[4]

Benefiting employee has the same meaning here as for the ratio percentage test. For purposes of an employer contribution, it means an employee who is receiving an allocation of contributions or forfeitures. In the 401(k) portion of the plan (which must be tested separately), it means a participant who is eligible to make elective deferral contributions (regardless of whether he or she actually elects deferral). In the 401(m) or matching contribution portion of the plan (which must also be tested separately), a benefiting employee is a participant who would receive a matching contribution if he or she makes elective deferrals (regardless of whether he or she actually elects deferral).

EXAMPLE 5-1. Job Classification Used to Exclude Certain Employees. A profit-sharing plan's eligibility conditions are age 21 and one year of service. The plan excludes hourly paid employees. The entry dates are January 1 and July 1. The plan year is the calendar year. The corporation maintaining the plan has 50 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:

(1)	Workforce during plan year	50
(2)	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates	5
(3)	Number of nonbenefiting employees not included in (2) who terminate before year end with 500 or fewer hours of service	0

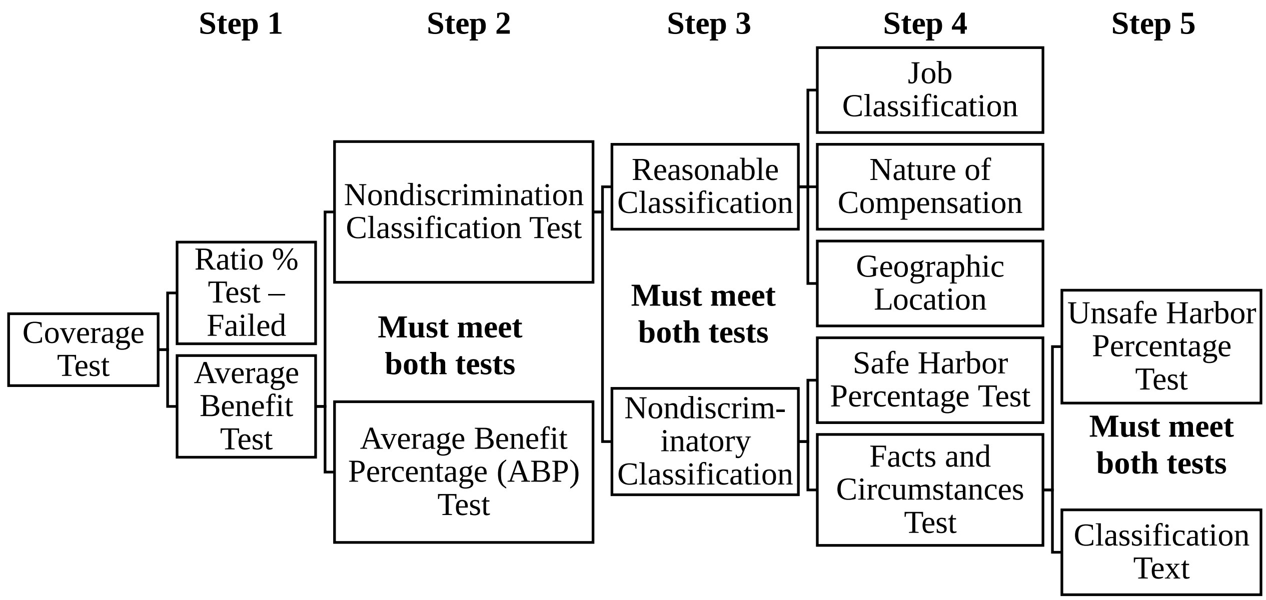
The coverage testing continues as follows:

[4] Treas. Reg. §1.410(b)-4(c)(3).

		HCEs	NHCEs	Total
(4)	Coverage testing group (1) − (2) − (3)	5	40	45
(5)	Employees in the coverage testing group who do not benefit under the plan:			
	Number of employees in (4) who terminate before year end with more than 500 hours credited during plan year	0	2	2
	Number of employees in (4) who are paid hourly	0	20	20
(6)	Benefiting group (4) − (5)	5	18	23
(7)	Coverage ratios (6)/(4)	100%	45%	
(8)	Ratio percentage (7) for NHCE/(7) for HCE			45%

The classification of employees who benefit under the plan is salaried employees who have completed the age and service requirements. This is a reasonable classification. The plan's coverage ratio is only 45 percent, not enough to pass the ratio percentage test. The NHCE concentration of this employer is determined by dividing the NHCE number in step (4) (that is, the number of nonexcludable employees who are NHCEs or, put another way, the number of NHCEs in the coverage testing group) by the total employee number in step (4) (the total number of employees in the testing group), to get 88 percent (40/45). Referring to the table in the Appendix, we find that the plan's safe harbor percentage is 29 percent. The plan passes the nondiscriminatory classification test because the ratio percentage in step (8) is at least 29 percent.

The nondiscrimination classification test is summarized in step 3 and 4 below:



AVERAGE BENEFIT PERCENTAGE (ABP) TEST

Under the second part of the average benefit test, the plan's average benefit percentage (ABP) must be equal to at least 70 percent.[5]

ABP Calculation

To calculate the ABP, additional information is required regarding the actual allocations or benefits accrued by the employees for the plan year. The ABP is determined by dividing the NHCE actual benefit percentage by the HCE actual benefit percentage.[6] Employees are identified as NHCEs or HCEs in the same manner as for the ratio percentage test.

The **NHCE actual benefit percentage** is the average of the employee benefit percentages determined for each NHCE in the coverage testing group. The **HCE actual benefit percentage** is the average of the employee benefit percentages determined for each HCE in the coverage testing group.

Each employee's benefit percentage must be calculated first before the HCE and NHCE actual benefit percentages can be calculated. There are several options for calculating the individual employee benefit percentages.

If the employer maintains more than one qualified plan, the ABP testing group must be identified, and data from all of the plans of the employer (including all companies in the controlled or affiliated service group) are used to calculate the employee benefit percentages. All employees in

[5] Treas. Reg. §1.410(b)-5(a).
[6] Treas. Reg. §1.410(b)-5(b).

the coverage testing group, not just the employees who are benefiting under the plan being tested, are taken into account to compute these employee benefit percentages.

Computing Employee Benefit Percentages[7]

An employee's **employee benefit percentage** may be an allocation rate or a benefit rate. Normally, if the plan is a defined contribution plan, the percentage is expressed as an allocation rate. If the plan is a defined benefit plan, the percentage is expressed as a benefit rate. Only employer-derived benefits are taken into account.[8] If there are after-tax employee contributions made to the plan, benefits attributable to those contributions are disregarded. Remember that elective deferrals under a 401(k) arrangement, which includes pre-tax elective contributions and designated Roth contributions, are considered employer contributions and are included in an employee's benefit percentage.

Allocation Rate

The allocation rate in a defined contribution plan is determined by dividing the allocations for the plan year by the employee's compensation for the plan year.[9] Allocations are all employer contributions (including elective deferrals and matching contributions, if any) and forfeitures. This calculation is also used to determine allocation rates for IRC §401(a)(4) nondiscrimination testing purposes (which will be discussed in Chapter 6).

Benefit Rate

The **benefit rate** in a defined benefit plan is the increase in the employee's accrued benefit for the plan year. The methods available to determine the benefit rate are the same as those used for IRC §401(a)(4) nondiscrimination testing purposes,[10] including the use of either the current year method or the accrued-to-date method. If all plans being tested are defined benefit plans, a simplified method of calculating the benefit rates may be available.[11]

Cross-Testing Available

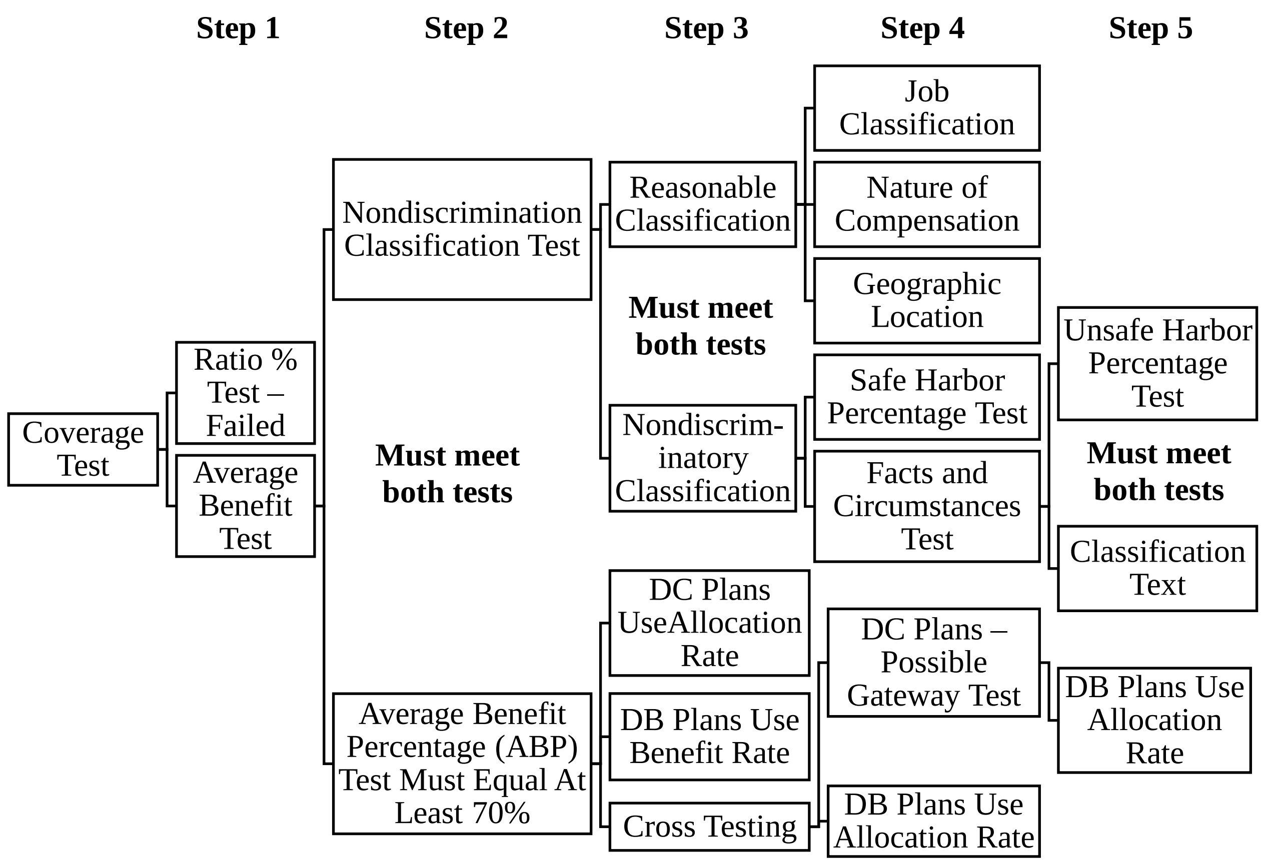
Instead of performing the test on the basis of allocation rates, a defined contribution plan may use benefit rates. Similarly, a defined benefit plan may use allocation rates instead of benefit rates. This is known as cross-testing, and the method of computing the rates is outlined in the IRC §401(a)(4) regulations.[12] Cross-testing may be used to perform the average benefit test if the plan (or one of the plans in the ABP testing group) also uses cross-testing for IRC §401(a)(4) nondiscrimination purposes, or if both a defined contribution plan and a defined benefit plan are included in the ABP testing group.

A defined contribution plan is not eligible to be cross-tested for IRC §401(a)(4) nondiscrimination purposes unless it satisfies a gateway test (covered in chapter 6) or one of the regulatory exceptions

[7] Treas. Reg. §1.410(b)-5(d)(5).
[8] Treas. Reg. §1.410(b)-5(d)(2).
[9] Treas. Reg. §1.401(a)(4)-2.
[10] Treas. Reg. §1.401(a)(4)-3.
[11] Treas. Reg. §1.410(b)-5(e)(4).
[12] Treas. Reg. §1.401(a)(4)-8.

to the gateway test.[13] The gateway test does not apply if the sole purpose for converting allocation rates into benefits is to determine the employee benefit percentages for the ABP test for coverage purposes. In other words, if the defined contribution plan is still being tested on the basis of contributions (i.e., looking at allocation rates) for IRC §401(a)(4) nondiscrimination testing purposes, but the allocations are expressed as benefits to run the ABP test to support the coverage test under IRC §410(b) for that plan (or for another plan maintained by the employer), the gateway condition does not have to be satisfied.[14]

Steps 3-5 in the following illustration summarize the steps involved in computing the average benefit percentage test.



Imputing Permitted Disparity

The employee benefit percentages may be adjusted by imputing permitted disparity.[15] This is a procedure by which the percentages are increased to approximate the benefits provided through employer contributions to Social Security (i.e., FICA contributions) on behalf of the employee. Imputing disparity usually increases the employee benefit percentage for an NHCE by a greater percentage than it does for HCEs, because contributions for Social Security are capped at the Social

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[13] Treas. Reg. §1.401(a)(4)-8(b)(1)(i).
[14] Treas. Reg. §1.410(b)-5(d)(5)(i), which explains the manner in which benefit percentages are calculated for the ABP test, and does not cross-reference the gateway requirement under Treas. Reg. §1.401(a)(4)-8(b)(1).
[15] Treas. Reg. §1.401(a)(4)-7.

Security Taxable Wage Base, resulting in lower contributions (as a percentage of compensation) for those who earn in excess of the Taxable Wage Base.

Compensation Definition

The compensation used to determine allocation rates or benefit rates must satisfy IRC §414(s). The same definition of IRC §414(s) compensation must be used to determine the allocation rate or benefit rate for all employees. This might require using a definition that is different from the one used to perform allocations.

EXAMPLE 5-2. Average Benefit Test Compensation. A profit-sharing plan covering salaried employees is being tested under the average benefit test. The employer also maintains a profit-sharing plan covering hourly paid employees. The hourly paid plan passes the ratio percentage test. The employer's contribution is allocated using a pro rata allocation formula under both plans, based on compensation. However, the salaried plan defines compensation as total W-2 compensation, whereas the hourly paid plan excludes overtime. For the current plan year, the salaried employees who benefited under their plan received an allocation equal to 8 percent of W-2 compensation, and the hourly paid employees who benefited under their plan received an allocation equal to 4 percent of compensation (exclusive of overtime).

M is a participant in the hourly paid plan. M's total W-2 compensation for the plan year is \$33,000, but M's compensation exclusive of overtime is \$26,000. M's allocation for the plan year is 4% x \$26,000, or \$1,040. The average benefit test must take into account the plan covering the hourly paid employees because that plan is part of the ABP testing group. If the average benefit test is performed by using 8 percent as the allocation rate under the salaried employee plan, then the allocation rates of the hourly paid employees must be determined on the basis of their total W-2 compensation, i.e., the same compensation definition that is being used to determine that the HCE allocation is 8 percent. M's allocation rate is not 4 percent, but rather is 3.15 percent, which is the percentage that M's allocation (\$1,040) represents of M's total W-2 compensation (\$33,000).

Averaging Period Permitted

Employee benefit percentages are normally based on allocations or accruals for the plan year being tested (the current plan year). The employer may elect to compute employee benefit percentages as the average of the employee benefit percentages for the current plan year and the preceding one or two plan years.[16] For example, to calculate the employee benefit percentages for an average benefit test performed for the 2020 plan year, the employer has three options:

- Use each employee's benefit percentage for the 2020 plan year;
- Average each employee's benefit percentages for the 2019 and 2020 plan years; or

[16] Treas. Reg. §1.410(b)-5(e)(5).

- Average each employee's benefit percentages for the 2018, 2019 and 2020 plan years.

Certain Distributed Amounts Must Be Included in Employee Benefit Percentage

When calculating an employee's benefit percentage, all contributions allocated (or benefits accrued) for the plan year are included, even if those amounts have been distributed to the participant.

The IRS has not dealt clearly with this issue in the context of corrective distributions under IRC §§401(k), 401(m), 402(g) and 415. Presumably, corrective distributions under IRC §§401(k) or 401(m) (i.e., excess contributions under the actual deferral percentage (ADP) test or excess aggregate contributions under the actual contribution percentage (ACP) test) should be included in calculating a participant's employee benefit percentage because those amounts are included in the nondiscrimination test.

In some cases, all or a portion of the excess contributions under IRC §401(k)(8) that are allocable to an HCE will be recharacterized as catch-up contributions under IRC §414(v) and will not be distributed.[17] Elective deferrals for the current plan year that are recharacterized as catch-up contributions would be excluded from the employee benefit percentage for the ABP test.

Whether to apply this inclusion rule to excess deferrals under IRC §402(g) is less clear. Treas. Reg. §1.415(c)-1(b)(2)(ii) (D) provides that excess deferrals that are distributed by the April 15th deadline under IRC §402(g)(2) are not treated as annual additions for IRC §415 purposes. However, Treas. Reg. §1.402(g)-1(e)(1)(ii) provides that the excess deferrals of NHCEs are excluded from the nondiscrimination test under IRC §401(k) (i.e., the ADP test), but the excess deferrals of the HCEs are included in the ADP test. With the difference in treatment between HCEs and NHCEs for nondiscrimination testing purposes, it is recommended that excess deferrals be included in the employee benefit percentage, even if they are distributed by the April 15th deadline.

With excess annual additions under §415, there is a stronger argument to disregard excess annual additions allocated to a participant when calculating that participant's benefit percentage, provided the plan is taking corrective action. Excess annual additions that are reallocated to other participants or to a suspense account, or are used as credit against future allocations, should be treated as allocations to the other participants (if reallocated in the same year) or as allocations for the year in which they are allocated from the suspense account or are used to reduce allocations, and included in the benefit percentages of the participants who receive the allocations of those amounts. Similarly, elective deferrals or after-tax employee contributions that are distributed to correct a violation of IRC §415(c) should be disregarded in determining the benefit percentage because such amounts are excluded for nondiscrimination testing purposes (i.e., ADP test and ACP test), regardless of whether an employee is an HCE or an NHCE.

Plans Included in the ABP Testing Group

The most important aspect of the average benefit percentage test is the determination of the plans included in the test. We will call this the ABP testing group. If the employer maintains more than

[17] Treas. Reg. §1.414(v)-1(d)(2)(iii).

one plan, generally all other plans are included in the ABP testing group, even if the other plans separately satisfy coverage under the ratio percentage test.[18] This is a special aggregation rule and is required regardless of whether the plans are otherwise permissively aggregated for coverage testing purposes pursuant to Treas. Reg. §1.410(b)-7(d). Because of the aggregation aspect of this test, the average benefit percentage calculated for the ABP testing group will apply to all plans included in the ABP testing group. Therefore, if the average benefit percentage for the ABP testing group is at least equal to 70 percent, then all plans included in the ABP testing group have passed this part of the average benefit test.

As a general rule, the 401(k) portion of a plan and the 401(m) portion of a plan must be tested separately for coverage. However, when determining the ABP testing group, 401(k) and 401(m) plans are aggregated with non-401(k) and non401(m) plans.[19]

EXAMPLE 5-3. Aggregation of Benefits from All Plans for ABP Test. Employer T maintains a profit-sharing plan with a 401(k) arrangement. The plan also includes matching contributions, so there is also a 401(m) arrangement. The 401(k) arrangement and the 401(m) arrangement, which are tested separately for coverage, pass the ratio percentage test. However, because of the failure of a number of NHCEs in the coverage testing group to receive profit-sharing allocations for the plan year, the profit-sharing allocation portion of the plan does not pass the ratio percentage test.

In applying the average benefit test to the profit-sharing allocation portion of the plan, the ABP testing group includes the 401(k) and 401(m) portions of the plan. Therefore, each employee's benefit percentage must include his or her allocation of employer contributions and forfeitures under the profit-sharing portion of the plan, as well as the elective deferrals under the 401(k) portion, and matching contributions under the 401(m) portion.

Catch-up contributions are elective deferrals, but are exempt from certain statutory rules, as listed in IRC §414(v). IRC §414(v)(B) references IRC §410(b) as one of the IRC sections in which a plan is not treated as failing solely by reason of the making of (or the right to make) catch-up contributions. What is the implication of this rule? Consistent with its approach under the top-heavy rules, the Treasury disregards catch-up contributions made for the current plan year for purposes of the average benefit test.[20] Thus, the catch-up contributions for that plan year are disregarded (including excess contributions that are recharacterized as catch-up contributions).

401(k) and 401(m) plans are included in the ABP testing even if the 401(k) plan satisfies the ADP safe harbor under IRC §401(k)(12) or §401(k)(13), and even if the 401(m) plan consists solely of matching contributions that satisfy the ACP safe harbor under IRC §401(m)(11) or §401(m)(12).

[18] Treas. Reg. §1.410(b)-7(e)(1).
[19] Treas. Reg. §1.410(b)-7(e)(1), the third sentence of which requires the ABP testing group to include all plans that could be permissively aggregated if paragraph (c)(1) of Treas. Reg. §1.410(b)-7 (pertaining to the disaggregation of 401(k) and 401(m) arrangements) did not apply.
[20] Treas. Reg. §1.414(v)-1(d)(3)(ii).

Elective deferrals designated by an employee as Roth contributions are taken into account in the ABP testing group in the same fashion as pre-tax elective deferrals. Thus, all designated Roth contributions are included in the average benefit percentage, other than those that are catch-up contributions for the current plan year.

Normally, employee stock ownership plans (ESOPs) are tested separately for coverage. However, when determining the ABP testing group, ESOPs and non-ESOPs are combined.[21]

An employer may aggregate other plans into the coverage testing group under certain circumstances. These permissive aggregation rules are the same for the ABP as they were for the ratio percentage test.

Plans Not Included in the ABP Testing Group

When calculating the ABP, union plans are not combined with nonunion plans, and plans maintained by a qualified separate line of business (QSLOB) are not aggregated with plans of another QSLOB. For example, the ABP testing group for a nonunion plan does not include plans (or portions of a plan) maintained for union employees. Similarly, the ABP testing group for a plan maintained by a QSLOB does not include plans (or portions of a plan) maintained for the employees of a different QSLOB.

If the employer elects to disaggregate otherwise excludable employees with respect to the plan being tested, as permitted by Treas. Reg. §1.410(b)-7(c)(3), the portion of the plan (and any other plan) that covers such otherwise excludable employees is not included in the ABP. Otherwise excludable employees are those employees who are covered by the plan but would have been excluded from the plan if the plan had used the statutory age and service requirements (i.e., age 21 and one year of service).

Uniform Method of Calculating Rates

All plans included in the test must use the same method of calculating employee benefit percentages: allocation rates or benefit rates. For example, if the ABP testing group includes one defined contribution plan and one defined benefit plan, either the allocation rates are determined for both plans, or the benefit rates are determined for both plans. Similarly, even if the ABP testing group consists of two defined contribution plans, both plans must use either allocation rates or benefit rates to determine the ABP, even if the plans pass nondiscrimination testing under IRC §401(a)(4) using different rates. Determining allocation rates for a defined benefit plan or benefit rates for a defined contribution plan involves cross-testing principles.

If the ABP testing group includes at least one defined contribution plan and at least one defined benefit plan, the employer may elect to separately test plans of the same type.[22] Under this option, two ABPs are computed: one for the defined contribution plans and one for the defined benefit plans. When computing the ABP for plans of one type, the employee benefit percentages of the employees in the plans of the other type are assumed to be zero. The ABP for the defined

[21] Treas. Reg. §1.410(b)-7(e)(1), the third sentence of which requires the ABP testing group to include all plans that could be permissively aggregated if paragraph (c)(2) of Treas. Reg. §1.410(b)-7 (pertaining to the disaggregation of ESOPs) did not apply.
[22] Treas. Reg. §1.410(b)-5(e)(3).

contribution plans must be calculated on the basis of allocation rates, and the ABP for the defined benefit plans must be calculated on the basis of benefit rates under this special rule. In other words, cross-testing is not allowed. A plan may not rely on this special testing option unless the plans of the other type also satisfy the average benefit test using this special option or satisfy the ratio percentage test.[23] For example, the employer's defined contribution plans could not use this special testing option unless its defined benefit plans also satisfy coverage using this option or the ratio percentage test.

The rules relating to aggregation of plans in the ABP testing group do not require that the aggregated plans have the same plan year.[24] Therefore, it is possible to have plans in the ABP testing group with different plan years. If there is more than one plan in the ABP testing group, but at least two plans have different plan years, calculate the employee benefit percentages for the plan years ending in the same calendar year.[25] Compare this rule to the one for permissive aggregation of plans (defined later in the chapter) to pass the ratio percentage test or the nondiscriminatory classification test as permitted under Treas. Reg. §1.410(b)-7(d). Those rules require plans to have the same plan year to be permissively aggregated.[26] For example, if an employer maintains a profit-sharing plan with a December 31 plan year, and a money purchase pension plan with a June 30 plan year, the plans may not be permissively aggregated, but, if either plan is relying on the average benefit test, the ABP test is run by including both plans in the ABP testing group.

Frozen plans maintained by the employer are included in applying the ABP test, although a frozen plan will not provide an accrual for the current plan year unless the plan was frozen during that year, after benefits had already accrued. Usually a frozen plan will not have any effect on the ABP calculations.

All Employees in Coverage Testing Group Included

The ABP must reflect the employee benefit percentages of all employees in the coverage testing group, regardless of whether they are benefiting in any plan maintained by the employer. If an employee does not benefit in any plan, his or her employee benefit percentage is zero percent. In Example 5-1, the coverage testing group consisted of 45 employees, which included the hourly paid employees who had satisfied the plan's age and service requirements. When computing the ABP, all 45 employees are included, even though only 23 employees are actually benefiting under the plan being tested. If the plan being tested is the only plan maintained by the employer, then the hourly paid employees in the coverage testing group who do not benefit from the plan have an employee benefit percentage equal to zero for purposes of calculating the ABP. If the employer maintains another plan that is included in the ABP testing group, then the employees in the coverage testing group who do not benefit from the plan being tested would have a benefit percentage of zero, only if they also fail to benefit under all of the plans included in the ABP testing group.

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[23] Treas. Reg. §1.410(b)-5(e)(3)(ii).
[24] Treas. Reg. §1.410(b)-7(e).
[25] Treas. Reg. §1.410(b)-5(d)(3)(ii) and (d)(5)(ii).
[26] Treas. Reg. §1.410(b)-7(d)(5).

The coverage testing group for the ABP is determined by applying the excludable employee rules as if the plans in the ABP testing group constitute a single plan.[27]

Employees Who Have Waived Participation

An employee who is in the coverage testing group is still taken into account in computing the ABP, even if that employee has waived participation in the plan, and even if that waiver is irrevocable. Treas. Reg. §§1.410(b)-5 and 1.410(b)-6 do not contain any special rules for modifying the coverage testing group for ABP calculation purposes merely because of participation waivers in effect.

Different Eligibility Age of Service Conditions

If there are two or more plans in the ABP testing group with different age or service conditions for eligibility, the coverage testing group for ABP purposes must be determined using the lowest applicable age and service conditions. For example, if one plan required one year of service and the other requires six months of service, only employees who fail to complete the six months requirement would be excludable for purposes of calculating the ABP. However, any employee, regardless of the plan in which he or she participates, who does not satisfy the age 21 and one-year-of-service requirement, may be disaggregated under the otherwise excludable testing option.

Application of Terminated Participants Exclusion to an ABP Testing Group that Includes More than One Plan

Participants who are not employed on the last day of the plan year, have completed 500 or fewer hours for the plan year, and fail to benefit under the plan, may be treated as excludable employees.[28] When applying this exclusion to the ABP testing group, a terminated participant would be excludable only if he or she fails to benefit under all of the plans included in the ABP testing group because the excludable employees are determined by treating all of the plans as a single plan.

EXAMPLE 5-4. Terminated Participant Exclusion Does Not Apply to ABP Test if 401(k) Plan is Part of Testing. Suppose a profit-sharing plan is performing the average benefit test because the employees who benefit from the employer's profit-sharing contribution do not satisfy the ratio percentage test. The plan also includes a 401(k) arrangement. The ABP testing group includes the 401(k) arrangement, even though that arrangement is treated as a separate plan under the coverage testing disaggregation rules.

J was eligible to participate in the 401(k) arrangement for the plan year. However, J did not benefit under the profit-sharing plan for the plan year because J terminated employment before the end of the plan year. J was credited with only 400 hours of service for the plan year. J is included in the ABP calculation because J is not an excludable employee with respect to the 401(k) arrangement, even though J would be an excludable employee under the profit-sharing portion

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[27] Treas. Reg. §1.410(b)-6(a)(2).
[28] Treas. Reg. §1.410(b)-6(f).

of the plan because of the terminated participant exclusion. The terminated participant exclusion does not apply to the 401(k) arrangement because J's hours of service for the plan year did not affect J's right to benefit under the 401(k) arrangement.

EXAMPLE 5-5. One Plan Maintained by Employer. An employer maintains a profit-sharing plan. The coverage testing group consists of 50 employees—five HCEs and 45 NHCEs. The benefiting group consists of 30 employees—five HCEs and 25 NHCEs. The NHCE ratio is 25/45, or 55.56 percent, and the HCE ratio is 5/5, or 100 percent. These ratios produce a coverage ratio of 55.56%/100%, or 55.56 percent, which passes the nondiscriminatory classification test. To pass the average benefit test, the plan's ABP must be at least equal to 70 percent. The ABP is calculated as follows:

(1)	Employee benefit percentages of HCEs:	10%, 8%, 6%, 5%, 5%
(2)	Employee benefit percentages of NHCEs:	10% (18 NHCEs), 9% (3 NHCEs), 7% (4 NHCEs), 0% (20 NHCEs)
(3)	Actual benefit percentage for HCEs: (sum of percentages in (1) divided by 5):	34%/5 = 6.8%
(4)	Actual benefit percentage for NHCEs: (sum of percentages in (2) divided by 45)	(180% + 27% + 28% + 0%)/45, or 235%/45 = 5.22%
(5)	Plan's average benefit percentage (4)/(3):	76.76%

The averages in (3) and (4) include all employees in the coverage testing group, even if they are not benefiting under the plan. Therefore, the 20 employees with zero percent are included in step (4). The ABP is at least 70 percent, so the plan passes this test. The plan's coverage ratio of 55.56 percent satisfies the nondiscriminatory classification test. Therefore, the plan passes the average benefit test.

EXAMPLE 5-6. Two Plans Maintained by Employer. An employer maintains two plans—a profit-sharing plan and a money purchase pension plan. All employees who have completed a year of service are eligible for the profit-sharing plan. Only salaried employees who have completed a year of service are eligible for the money purchase pension plan. The coverage testing group consists of 50 employees—five HCEs and 45 NHCEs. In the profit-sharing plan, the benefiting group consists of 48 employees—five HCEs and 43 NHCEs. The NHCE ratio percentage for the profit-sharing plan is 43/45, or 95.56 percent, so the profit-sharing plan passes the ratio percentage test. In the money purchase pension plan, the benefiting group consists of 30 employees—five HCEs and 25 NHCEs. The NHCE ratio percentage is 25/45, or 55.56 percent, and the HCE ratio is 5/5, or 100 percent. These ratios produce a plan ratio percentage of 55.56%/100%, or 55.56 percent, which does not pass the ratio percentage test but passes the nondiscriminatory classification test. The money purchase pension plan must satisfy the average benefit test to pass coverage.

To pass the average benefit test, the plans' ABP must be at least equal to 70 percent. The ABP must include the benefit percentages of both plans, even though the profit-sharing plan passes the ratio percentage test. The ABP is calculated as follows:

(1)	Employee benefit percentages of HCEs:	15%, 12%, 10%, 8%, 8%
(2)	Employee benefit percentages of NHCEs:	13% (15 NHCEs), 9% (6 NHCEs), 6% (4 NHCEs), 4% (18 NHCEs), 0% (2 NHCEs)
(3)	Actual benefit percentage for HCEs:	53%/5 = 10.6% (sum of percentages in (1) divided by 5)
(4)	Actual benefit percentage for NHCEs:	(195% + 54% + 24% + 72% + 0%)/45 = (sum of percentages in (2) divided by 45)
(5)	Average benefit percentage (ABP) (4)/(3):	72.36%

The employee benefit percentage in (1) and (2) for each employee is a combined percentage based on the allocations under both plans. The employees with zero percent are those who participate in neither plan. The money purchase pension plan passes the average benefit test because the ABP is at least 70 percent.

EXAMPLE 5-7. Defined Benefit Plan Included in Testing Group. If, in Example 5-6, the plan was a defined benefit plan instead of a money purchase pension plan, the same principles apply, except the employee benefit percentages must reflect the benefits from the profit-sharing plan and the defined benefit plan. To make that calculation, the employer may calculate all percentages on a benefits basis (i.e., converting the profit-sharing allocations into an equivalent benefit rate) or calculate all percentages on an allocations basis (i.e., converting the defined benefit accrual into an equivalent allocation rate). Alternatively, the employer may be eligible to use the separate testing option described above, where separate ABPs are calculated for each plan because one plan is a defined contribution plan and the other plan is a defined benefit plan.

EXAMPLE 5-8. Separate Divisions of the Workforce Covered by Separate Plan. A company has employees in Denver and in Seattle. The company maintains two separate profit-sharing plans, one for each location. Both plans require one year of service and attainment of age 21 to be eligible to participate in the plan. The Denver plan excludes Seattle employees, and the Seattle plan excludes Denver employees. In each plan, a participant is entitled to an allocation of employer contributions if he or she is employed at the end of the year and is credited with at least 1,000 hours of service for the plan year.

For the year at issue, the profit-sharing contribution for the eligible Denver employees is 6 percent of W-2 compensation, and the contribution for the eligible Seattle employees is 12 percent of W-2 compensation.

Ratio Percentage Test for Seattle Plan. The ratio percentage test result for the Seattle plan is as follows:

(1)	NHCE ratio percentage:	**35.62%** (i.e., number of NHCEs who benefit in the Seattle plan (26), divided by all NHCEs in the coverage testing group (73), including those who work in Denver (numerical information about the NHCEs in the coverage testing group is below)
(2)	HCE ratio percentage:	**75%** (i.e., number of HCEs who benefit in the Seattle plan (6), divided by all HCEs in the coverage testing group (8), including those who work in Denver (numerical information about the HCEs in the coverage testing group is below)
(3)	Coverage ratio percentage:	**47.49%** (i.e., NHCE ratio/HCE ratio) - ratio percentage test failed.

Ratio Percentage Test for Denver Plan. The Denver plan, which has a much greater percentage of the NHCE workforce, easily passes the ratio percentage test because the NHCE ratio percentage is greater than the HCE ratio percentage. We know from the information shown below that the HCE ratio percentage in the Denver plan is 25 percent (only two out of eight benefiting under the Denver plan). We know from the information below that the NHCE ratio percentage is 52.05 percent (38 out of 73 benefiting under the Denver plan). The ratio percentage is, therefore, 52.05%/25%, or 208.2%, and the Denver plan passes the test.

Because the Seattle plan failed the ratio percentage test, we must move on to the average benefit test. Based on the following information, does the Seattle plan pass the average benefit test?

<u>Part I of the average benefit test - passing the nondiscriminatory classification test</u>. There are two parts of the nondiscriminatory classification test: the reasonable classification and the nondiscriminatory classification.

<u>Reasonable Classification</u>

The regulations provide that classifications based on job categories, nature of compensation or geographic location (among other similar criteria) generally constitute reasonable classifications. The classification here is one of geographic location and is considered reasonable.

<u>Nondiscriminatory Classification</u>

This portion of the determination can be passed through the use of an objective numerical test—is the plan's ratio percentage greater than the safe harbor percentage?

(1)	NHCE concentration percentage:	**90%***
* This is the percentage of the coverage testing group that consists of NHCEs. Employees in both Denver and Seattle are counted in this determination, even though we are testing the Seattle plan under the average benefit test. The actual numbers are 73 NHCEs and eight HCEs, for a total of 81 employees in the coverage testing group. The NHCE concentration percentage is 73/81, or 90 percent.		
(2)	Safe harbor percentage under Treas. Reg. §1.410(b)-4:	**27.5%***
* This percentage is determined by looking at the table in Treas. Reg. §1.410(b)-4, as repeated in Appendix A. These rates are based on the concentration percentage, calculated in (1) above.		

The nondiscriminatory classification element of the test passes because the Seattle plan's coverage ratio percentage of 47.49 percent (taken from the ratio percentage test) is at least equal to the safe harbor percentage.

<u>Part II of the average benefit test - passing the average benefit percentage test.</u>

In this example, the ABP test will be run using allocation rates.

Allocation Rate under Seattle Plan. The plan uses a pro rata allocation method based on W-2 compensation. The allocation rate received by the eligible participants in the Seattle plan who benefit for the plan year equals 12 percent of compensation. (This is generally determined by dividing each eligible participant's allocation of employer contributions and forfeitures by compensation. In this case, because it was a uniform pro rata allocation, the allocation rate is the same for each participant.) The allocation rate is the employee benefit percentage.

Allocation Rate under Denver Plan. The Denver plan also allocates employer contributions under a pro rata formula using W-2 compensation. If the plans used different definitions of compensation to perform allocations, a uniform definition would have to be used to calculate allocation rates for average benefit test purposes. The allocation rate (employee benefit percentage) received by eligible participants in the Denver plan who benefit for the plan year equals 6 percent of compensation.

NHCE Actual Benefit Percentage. The actual benefit percentage of NHCEs (both Seattle and Denver plans are taken into account, even though it is the Seattle plan that is being tested under the average benefit test) is calculated as follows.

Employee benefit percentages for 73 NHCEs included in the coverage testing group

• 26 Seattle NHCEs @ 12%

o 38 Denver NHCEs @ 6%

NHCEs in coverage testing group @ 0% because they terminated before end of plan year = 9 (seven in Denver and two in Seattle)

Average (which is the actual benefit percentage) is
7.40% [((26 x .12)+(38 x .06))/(26 + 38 + 9)]

HCE Actual Benefit Percentage. The actual benefit percentage of HCEs (both Seattle and Denver plans are taken into account) is calculated as follows.

Employee benefit percentages for eight HCEs included in the coverage testing group

o Six Seattle HCEs @ 12%

o Two Denver HCEs @ 6%

o None @ 0%

Average (actual benefit percentage) is 10.% [((6 x .12)+(2 x .06))/(6 + 2)]

The plan's ABP is 7.40% (the NHCE actual benefit percentage) divided by 10.5% (the HCE actual benefit percentage), or 70.48 percent. The plan passed the test because the ABP is at least 70 percent.

Fail-Safe Language Might Preclude Use of Average Benefit Test

Some plans include what we call fail-safe language, which prevents the plan from failing coverage. Typically, these provisions will mandate that the plan satisfy the ratio percentage test. If the coverage ratio, based on the participants who would benefit under the plan in the absence of fail-safe language, will be less than 70 percent, the fail-safe language automatically causes a specified group of otherwise eligible employees to benefit for the plan year. The specified group might be determined in the order of termination dates (e.g., employees who terminated during the plan year are added to the plan, in reverse order of their termination dates, until the ratio percentage test is satisfied), or by reference to compensation (e.g., the employees who failed to benefit are added to the plan, in reverse order of their compensation amounts for the plan year, until the ratio percentage test is satisfied). When a fail-safe provision is in the plan, the plan administrator is required to follow the terms of the plan, and cannot deny the affected employees an allocation (or benefit accrual) merely because the administrator can demonstrate that the plan is able to pass the average benefit test. (A failure to follow the terms of the plan is a qualification defect.[29]) If an employer wants the flexibility of testing the plan for compliance under the average benefit test if the plan fails the ratio percentage test, it should not adopt fail-safe language.

EXAMPLE 5-9. Fail-Safe Language. A profit-sharing plan includes fail-safe language that provides that, in the event the plan fails the ratio percentage test for a plan year, otherwise eligible participants who failed to benefit are added back in the plan for that plan year. Participants are added back on the basis of their termination dates starting with the employee who had the latest termination date and working in reverse order until the ratio percentage test is satisfied.

For the current plan year, the plan has ten nonexcludable employees: one HCE and nine NHCEs. Of the nine NHCEs, three terminated during the plan year. Under the terms of the plan, a participant receives an allocation of employer contributions only if he or she is employed on the last day of the plan. Consequently, only six of the nine NHCEs, or 66.67 percent, are eligible for an allocation of employer contributions. The HCE ratio percentage is 100 percent.

Because a ratio of 66.67 percent would cause the plan to fail the ratio percentage test, the plan's failsafe language is invoked. The three terminated NHCE participants are M, H and K. Their termination dates are July 15, October 10 and November 24, respectively. The plan year ends December 31. Because K's termination occurred latest in the plan year, K is added in for the plan year and shares in the allocation of employer contributions. By adding K, the NHCE ratio percentage is 7/9, or 77.78 percent. M and H are not added back under the fail-safe language because, once K is added, the plan passes the ratio percentage test. The plan administrator must add K to the allocation because of the fail-safe

[29] Rev. Proc. 2019-19, which outlines the Employee Plans Compliance Resolution System for correcting qualification defects.

language, even if the administrator could demonstrate that the plan would satisfy the average benefit test without benefiting K.

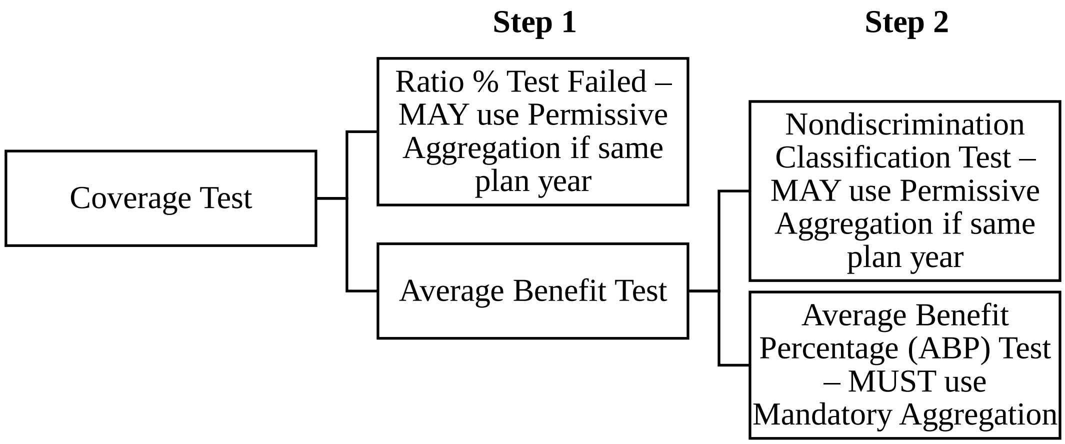
5.04: Permissive Aggregation of Plans

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 the other plan and treat the two plans as a single plan for testing purposes.[30] 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. 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.[31] The fact that the plans are combined to compute the ABP under the average benefit test does not mean the plans are permissively aggregated for coverage testing purposes, because Treas. Reg. §1.410(b)-7(e)(1) mandates the inclusion of all plans in the ABP testing group to perform this part of the average benefit test. Permissive aggregation might be used when one of the employer's plans fails the ratio percentage test, but 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 can pass if it is permissively aggregated with another plan maintained by the employer. The following illustrates these concepts:

[30] Treas. Reg. §1.410(b)-7(d).
[31] Treas. Reg. §1.410(b)-7(d)(1).



Testing a plan separately for coverage purposes means that, when determining the benefiting group for purposes of the ratio percentage test or for the nondiscriminatory classification test portion of the average benefit 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 generally is 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 the plan. Only employees who are excludable within the meaning of IRC §§410(b)(3) and (4) (i.e., union, nonresident aliens, did not pass the age/service requirements or terminated with 500 or fewer hours of service) are not taken into account in the coverage testing group. However, if the eligibility age and service requirements are different under the plans being permissively aggregated, 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.

ILLUSTRATION OF AGGREGATION FOR COVERAGE TESTING

An employer maintains two plans—a profit-sharing plan and a money purchase pension plan. All employees who have completed a year of service (regardless of age) are eligible for the profit-sharing plan. Only salaried employees who have completed a year of service (regardless of age) are eligible for the money purchase pension plan.

Coverage Testing Group for Each Plan

The coverage testing group consists of 50 employees—five HCEs and 45 NHCEs. The same coverage testing group applies to both plans, because the plans have the same eligibility service requirement (i.e., one year of service) and the exclusion of salaried employees in the money purchase pension plan does not affect the coverage testing group determination.

Benefiting Group for Each Plan

The benefiting groups, however, are different in the two plans because hourly employees benefit in the profit-sharing plan but not in the money purchase pension plan. In the profit-sharing plan, the benefiting group consists of 48 employees—five HCEs and 43 NHCEs. The NHCE ratio percentage for the profit-sharing plan is 43/45, or 95.56 percent, so the profit-sharing plan passes the ratio percentage test. In the money purchase pension plan, the benefiting group consists of only 30 employees—five HCEs and 25 NHCEs, because the hourly paid employees who are included in the coverage testing group are not benefiting under the money purchase pension plan. The NHCE ratio percentage is 25/45, or 55.56 percent, and the HCE ratio percentage is 5/5, or 100 percent. The NHCE and HCE ratio percentages under the money purchase pension plan produce a coverage ratio percentage of 55.56%/100%, or 55.56 percent, which does not pass the ratio percentage test.

Using Permissive Aggregation in the Money Purchase Pension Plan

Instead of running the average benefit test on the money purchase pension plan, the employer may aggregate the plan with the profit-sharing plan and may rerun the ratio percentage test for the plans as if they were a single plan. When the plans are aggregated, the benefiting group includes any employee who benefits under either plan. Therefore, the coverage ratio percentage for the aggregated plans is 95.56 percent. In other words, through permissive aggregation, the money purchase pension plan determines its coverage ratio to be 95.56 percent because it is treated as a single plan with the profit-sharing plan for purposes of applying the ratio percentage test. Note that the coverage testing group is the same when the plans are permissively aggregated because the plans have identical eligibility service requirements (i.e., one year of service) and neither plan has an age requirement.

What's the Catch? Nondiscrimination Testing!

If the employer permissively aggregates two plans to pass the ratio percentage test or the nondiscriminatory classification test, it must also perform nondiscrimination testing for those plans on a combined basis. Under the example above, the allocations under the money purchase pension plan must be combined with the allocations under the profit-sharing plan to perform nondiscrimination testing under IRC §401(a)(4).

EXAMPLES APPLYING THE PERMISSIVE AGGREGATION TESTING OPTION

EXAMPLE 5-10. Plans Permissively Aggregated for Ratio Percentage Test. An employer maintains two profit-sharing plans: one for hourly paid employees and the other for salaried employees. You have the following information for the current plan year:

o Nonexcludable employees are the employees in the coverage testing group (i.e., the employees who are not excludable employees under one of the categories described in Treas. Reg. §1.410(b)-6);

o Benefiting employees are the employees who are treated as benefiting under the plan for coverage testing purposes; and

o Nonexcludable and benefiting employees are broken down into NHCEs and HCEs to facilitate the computation of the ratio percentages needed to determine if the ratio percentage test or nondiscriminatory classification test passes. All employees fall into either the salaried employee classification or the hourly employee classification.

Classification	Nonexcludable NHCEs	Benefiting NHCEs	Nonexcludable HCEs	Benefiting HCEs
Salaried	80	70	20	19
Hourly	200	160	5	5
Totals	280	230	25	24

The ratio percentage for the aggregated group is:

NHCE ratio percentage: 230/280 = 82.14%
HCE ratio percentage: 24/25 = 96%
Ratio percentage: 82.14%/96% = 85.56%
The ratio percentage test passes.

EXAMPLE 5-11. Plans Not Aggregated for Ratio Percentage Test. Using the facts from Example 5-10, if the plans are not aggregated, the applicable coverage test is applied to each plan separately.

This means that in computing the NHCE ratio percentage and the HCE ratio percentage for the ratio percentage test, the number of employees benefiting (i.e., the numerator of each ratio percentage) is the number of employees benefiting only in that plan. However, the number of nonexcludable employees (i.e., the employees in the coverage testing group, which is the denominator of each percentage) must still include all employees, salaried and hourly (i.e., the numbers in the Totals row of the table), regardless of which plan is being tested. Applying these principles to the salaried plan, we get the following results:

NHCE ratio percentage: 70/280 = 25%
HCE ratio percentage: 19/25 = 76%
Ratio percentage: 25%/76% = 32.89%

The plan fails the ratio percentage test. Note that the numerator of the NHCE ratio percentage is 70, which is the number of NHCEs benefiting in the salaried plan, and the numerator of the HCE ratio percentage is 19, which is the number of HCEs benefiting in the salaried plan, because the plans are not being aggregated.

When the hourly plan is tested separately, we get the following results.

NHCE ratio percentage: 160/280 = 57.14%
HCE ratio percentage: 5/25 = 20%
Ratio percentage: 57.14%/20% = 285.70%

This plan passes the ratio percentage test. Note that the numerator of the NHCE ratio percentage is 160, which is the number of NHCEs benefiting in the hourly plan, and the numerator of the HCE ratio is 5, which is the number of HCEs benefiting in the hourly plan, because the plans are not being aggregated. However, the denominators are the same as the ones for the salaried plan because the plans have the same age and service eligibility conditions, so the coverage testing group with respect to each plan, is identical.

EXAMPLE 5-12. Average Benefit Test Passed with Plans Separately Satisfying Nondiscriminatory Classification Test. Assume in the prior example that the employer does not want to test the two plans as a single plan for nondiscrimination testing purpose. Thus, it needs to find a way for both plans to pass coverage separately. The hourly plan passes the ratio percentage test separately, as shown in Example 5-11 above, but the salaried plan fails the ratio percentage test when tested separately. However, the separately determined ratio percentage for the salaried plan shown in Example 5-11 above does satisfy the nondiscriminatory classification test, which is the first part of the two-part average benefit test.

The NHCE concentration percentage for this employer is 280/305, or 92 percent, because there are 280 total nonexcludable NHCEs out of 305 total nonexcludable employees (NHCEs and HCEs combined). Under the safe harbor percentage table from Treas. Reg. §1.410(b)-4 (which is reproduced in Appendix A), the safe harbor percentage for an employer with an NHCE concentration percentage of 92 percent is 26 percent. The ratio percentage for the salaried plan, when tested separately, is 32.89 percent (see Example 5-11 above), thus passing the nondiscriminatory classification test. Because the salaried plan can pass the nondiscriminatory classification test separately, if the second part of the average benefit test is satisfied (i.e., the ABP is 70 percent or higher), then the salaried plan will also be tested separately for nondiscrimination testing purposes. Note that the ABP will be calculated by taking into account both plans, as required by Treas. Reg. §1.410(b)- 7(e), but combining the plans solely for purposes of the ABP does not cause the plans to be treated as permissively aggregated.

EXAMPLE 5-13. Nondiscriminatory Classification Test Passed Through Permissive Aggregation. Let us change the facts of the example. Suppose you have the following data:

Classification	Nonexcludable NHCEs	Benefiting NHCEs	Nonexcludable HCEs	Benefiting HCEs
Salaried	50	40	20	19
Hourly	230	190	5	5
Totals	280	230	25	24

If the coverage test is applied separately to the salaried plan, the ratio percentage cannot pass the nondiscriminatory classification test.

NHCE ratio percentage: 40/280 = 14.29%
HCE ratio percentage: 19/25 = 76%
Ratio percentage: 14.29%/76% = 18.80%

The ratio percentage falls below the 26 percent safe harbor percentage for the nondiscriminatory classification test. In fact, it falls below the unsafe harbor percentage under Treas. Reg. §1.410(b)-4, so even a facts and circumstances test will not help here. Even if the ABP is 70 percent or greater, the salaried plan cannot pass the average benefit test because the nondiscriminatory classification test, which is the first part of the average benefit test, failed. Therefore, the salaried plan is unable to pass the average benefit test on its own. To pass the average benefit test, the salaried plan has to be permissively aggregated with the hourly plan so that the nondiscriminatory classification test can be satisfied. Because the plans are permissively aggregated to pass coverage, the plans will have to apply the nondiscrimination test under IRC §401(a)(4) on an aggregated basis (i.e., by treating the plans as a single plan).

When the plans are permissively aggregated, the coverage ratio percentage will pass the ratio percentage test. This will eliminate the need to calculate the average benefit test to show that the salaried plan passes coverage.

Permissively Aggregating 401(k) or 401(m) Arrangements

A 401(k) arrangement and a 401(m) arrangement in a plan are treated as separate plans for coverage testing. Thus, the decision of whether to aggregate the 401(k) arrangement with another 401(k) arrangement is made independently of the decision to aggregate two 401(m) arrangements or two non-401(k)/non-401(m) arrangements (e.g., the nonelective contribution portion of a plan that includes a 401(k) arrangement).

If two or more 401(k) or 401(m) arrangements are being permissively aggregated to pass coverage, then the applicable nondiscrimination test (ADP test for the 401(k) arrangement and ACP test for the 401(m) arrangement) is also performed on an aggregated basis. To illustrate, suppose the profit-sharing plans in the prior section included a 401(k) arrangement and/or a 401(m) arrangement. Those arrangements would have to be separately tested for coverage. Suppose the numbers of nonexcludable employees and benefiting employees shown in the above examples were also the numbers applicable for testing the coverage of the 401(k) (except that all eligible employees would be benefiting in the 401(k) portion of the plan) and 401(m) arrangements in each plan. In that case, if the ratio percentage test or the nondiscriminatory classification test is passed separately for each plan, the ADP and ACP tests could be performed separately. However, if the salaried plan must be permissively aggregated with the hourly plan to pass coverage, the 401(k) arrangements and 401(m) arrangements would also need to be permissively aggregated to pass coverage, and the ADP and ACP tests would be applied on an aggregated basis, as well.

Two plans may be permissively aggregated, even if the plans could pass coverage separately. An employer might permissively aggregate plans that pass coverage separately because it wants to aggregate them for nondiscrimination testing. Plans may not be aggregated for nondiscrimination testing unless they have been treated as permissively aggregated for coverage testing purposes.[32] For example, two 401(k) plans might have better overall ADP testing results if the plans are treated as a single plan. Thus, the employer elects to permissively aggregate the plans for coverage testing purposes, so that a single ADP test can be run for the plans together.

Special Rules for Aggregating ESOPs

Two or more ESOPs may not be permissively aggregated unless the following requirements are satisfied:[33]

- The proportion of qualifying employer securities to total plan assets is substantially the same for each ESOP; and
- Either:
- The qualifying employer securities held by all aggregated ESOPs are of the same class; or
- The ratios of each class held to all qualifying employer securities held are substantially the same for each ESOP.[34]

PLANS SUBJECT TO MANDATORY DISAGGREGATION CANNOT BE AGGREGATED

If two or more plans (or two or more portions of a single plan) must be tested separately under the mandatory disaggregation rules, they cannot be permissively aggregated to perform the ratio percentage test or the nondiscriminatory classification test.[35] Thus, coverage testing may not be satisfied by permissively aggregating:

[32] Treas. Reg. §§1.401(a)(4)-9(a), 1.401(k)-6, and 1.401(k)-5.
[33] Treas. Reg. §1.410(b)-7(d)(2) and Treas. Reg. §54.4975-11(e).
[34] Treas. Reg. §54.4975-11(e)(2).
[35] Treas. Reg. §1.410(b)-7(d)(2).

- A 401(k) plan or the 401(k) portion of a plan (or 401(m) plan or 401(m) portion of a plan) with a profit-sharing plan [or the nonelective contribution portion of a 401(k) plan) to enable either one to pass the ratio percentage test or the nondiscriminatory classification test;[36]
- An ESOP (or ESOP portion of a plan) with a non-ESOP (or non-ESOP portion of a plan);[37] or
- A collectively-bargained plan (or collectively-bargained portion of a plan) with a nonunion plan (or nonunion portion of a plan).[38]

EXAMPLE 5-14. Cannot Permissibly Aggregate Mandatorily Disaggregated Plans. An employer maintains a profit-sharing plan that covers only salaried employees. Because a substantially higher percentage of the HCEs are salaried employees, the coverage ratio percentage of the plan is only 25 percent. The employer also maintains a 401(k) plan for the hourly paid employees. The 401(k) plan provides matching contributions, but no employer nonelective contributions. The hourly paid employees' plan is not eligible for permissive aggregation with the profit-sharing plan. The hourly paid plan includes only a 401(k) arrangement (i.e., the elective deferrals) and a 401(m) arrangement (i.e., the matching contributions), neither of which is eligible for permissive aggregation with the profit-sharing plan because of the mandatory disaggregation rule under Treas. Reg. §1.410(b)-7(c)(1). Either the ratio percentage of the salaried plan will need to be increased (which might require making some of the hourly paid employees eligible for that plan) or the hourly paid plan will need to provide for employer nonelective contributions so that portion of the plan is eligible for permissive aggregation with the plan covering the salaried employees.

If two plans (or portions of two or more plans) are of the same disaggregated type, those plans (or portions of two or more plans) are eligible for permissive aggregation. For example, two ESOPs (or the ESOP portions of two plans) could be permissively aggregated. Similarly, two 401(k) arrangements under separate profit-sharing plans could be aggregated for coverage testing purposes.

SAME PLAN YEAR REQUIRED FOR PLANS TO BE PERMISSIVELY AGGREGATED

Plans cannot be permissively aggregated unless they have the same plan year.[39]

When plans are included in the ABP testing group for average benefit test purposes, there is no requirement for the plans to have the same plan year.[40] The same plan year requirement is only

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[36] Treas. Reg. §1.410(b)-7(c)(1).
[37] Treas. Reg. §1.410(b)-7(c)(2).
[38] Treas. Reg. §1.410(b)-7(c)(4)(ii)(B).
[39] Treas. Reg. §1.410(b)-7(d)(5).
[40] Treas. Reg. §1.410(b)-5(d)(3)(ii) and (d)(5)(ii).

imposed when plans are permissively aggregated to perform the ratio percentage test or the nondiscriminatory classification test portion of the average benefit test.

PERMISSIVELY AGGREGATED PLANS MAY HAVE DIFFERENT AGE OR SERVICE REQUIREMENTS

If the plans being aggregated have different age or service requirements for eligibility purposes, the excludable employees for the aggregated plans must be determined on the basis of the lowest age and service requirements.[41] This affects the determination of the coverage testing group for the permissively aggregated plans. For example, suppose an employer maintains two plans: Plan A and Plan B. Plan A's eligibility requirements are six months of service and no minimum age requirement, and Plan B's eligibility requirements are one year of service and age 21. If the plans are tested separately for coverage (i.e., if they are not permissively aggregated), the coverage testing group is determined separately for each plan based on that plan's eligibility requirements. Plan A's coverage testing group consists of all employees who satisfy the six-month service requirement (regardless of age), but Plan B's coverage testing group consists of only those employees who satisfy both the age 21 and one-year-of-service requirement. If there are any employees who have satisfied Plan A's service requirement but not Plan B's age and service requirements, there will be a greater number of employees in Plan A's coverage testing group than in Plan B's coverage testing group. But if the plans are permissively aggregated for coverage testing, the coverage testing group for the permissively aggregated plans is determined on a combined basis. In that case, all employees who satisfy the lower age and service requirements prescribed by Plan A are included in the coverage testing group of the permissively aggregated plans.

The disaggregation of otherwise excludable employees, as described in Treas. Reg. §1.410(b)-7(c), is available for permissively aggregated plans. In the above example, the otherwise excludable employees in the permissively aggregated Plan A and Plan B (resulting from the six-month eligibility rule in Plan A) could be disaggregated for coverage testing purposes.

NO DUPLICATIVE AGGREGATION

A plan may not be aggregated with two or more other plans to form more than one aggregated group for coverage testing purposes.[42] For example, suppose an employer maintains three plans: Plan A, Plan B and Plan C. The employer may not aggregate Plans A and B, and then separately aggregate Plans A and C, because it is including Plan A in two different aggregation groups. This would have the effect of using the benefiting data in Plan A twice to enable two different plans to satisfy either the ratio percentage test or the nondiscriminatory classification test through permissive aggregation. If the employer aggregates Plans A and B to perform the ratio percentage test or the nondiscriminatory classification test, then Plan C must be tested separately under those tests. In other words, the benefiting group under the permissively aggregated plans (Plans A and B) consists of employees who benefit under Plan A or Plan B, but the benefiting group under Plan C consists of employees who benefit under Plan C. Similarly, if the employer aggregates Plans A and C to perform the ratio percentage test or the nondiscriminatory classification test, then Plan B

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[41] Treas. Reg. §1.410(b)-6(b)(2).
[42] Treas. Reg. §1.410(b)-7(d)(3).

must be tested separately. That is, the benefiting group under the permissively aggregated plans (Plans A and C) consists of employees who benefit under Plan A or Plan C, but the benefiting group under Plan B consists of employees who benefit under Plan B. Rather than aggregating only two of the plans, the employer can aggregate all three plans to perform the ratio percentage test or the nondiscriminatory classification test. In that case, the benefiting group under the permissively aggregated plans (Plans A, B and C) consists of the employees who benefit under any of the three plans.

5.05: Special Testing Rules

SEPARATE TESTING OF CERTAIN PORTIONS OF A PLAN (MANDATORY DISAGGREGATION)

When one portion of a plan must be tested separately from another portion of the plan, the plan is said to be disaggregated for coverage testing purposes. The rules for disaggregation of plans are described in Treas. Reg. §1.410(b)-7(c). When plans are mandatorily disaggregated, each disaggregated portion of the plan must separately determine its coverage testing group and its benefiting group to determine if the ratio percentage test or the nondiscriminatory classification portion of the average benefit test is satisfied. In addition, each disaggregated portion of a plan may pass coverage under a different test. For example, a 401(k) arrangement might pass the ratio percentage test, but the nonelective contribution portion of the plan, which is disaggregated from the 401(k) arrangement for coverage testing purposes, might pass the average benefit test.

401(k) and 401(m) Arrangements

The portion of a plan that is a 401(k) arrangement and the portion of a plan that is a 401(m) arrangement must be disaggregated for coverage testing purposes.

ESOPs

The ESOP portion of a plan must be disaggregated from the non-ESOP portion of the plan for coverage testing purposes.[43] The coverage testing group is determined separately for each portion of the plan. Thus, if there are different eligibility conditions for each portion (e.g., the ESOP portion has different service requirements than the non-ESOP portion), there may be a different number of employees in the coverage testing group for each portion. Similarly, the benefiting group is determined separately for each component to determine if the ratio percentage test, or in the case of a plan relying on the average benefit test, the nondiscriminatory classification test, is satisfied. For example, if there is a last day employment condition on sharing in the allocation of the non-ESOP contribution but no last day rule for the ESOP portion, there may be a different number of employees benefiting under each disaggregated portion.

EXAMPLE 5-15. ESOP Mandatory Disaggregation. A company maintains a profit-sharing plan under which a portion of the plan is separately designated as

[43] Treas. Reg. §1.410(b)-7(c)(2).

an ESOP. The company contributes separately to the profit-sharing component and to the ESOP component. Contributions to the profit-sharing component are allocated under a permitted disparity formula, and are not required to be invested primarily in employer securities. Contributions to the ESOP component are used to make payments on a loan obtained by the ESOP to purchase employer securities. Employer securities are released from the suspense account and allocated to eligible participants under a pro rata allocation formula based on W-2 compensation. Coverage for the ESOP component is tested separately from the non-ESOP component.

If a plan is invested in employer securities, that fact alone does not create an ESOP portion of the plan. A plan (or portion of a plan) must be designated as an ESOP to be treated as an ESOP.[44]

Otherwise Excludable Employees

An elective disaggregation rule is provided for otherwise excludable employees. Although this disaggregation rule is elective, the regulations list it under mandatory disaggregation. The other disaggregation rules described in this section are not elective, except for QSLOB testing described below.

Union Employees

If collective-bargaining employees (union employees) are covered under a plan that also covers nonunion employees, the portion of the plan covering union employees must be disaggregated from the portion of the plan covering non-union employees.

QSLOBs

If a plan covers employees in more than one QSLOB, the plan may be disaggregated into separate portions representing employees assigned to each QSLOB.

Multiple Employer Plans

Plans covering employees of more than one unrelated business are disaggregated into portions representing each businesses' employees.

Plans Benefiting More Than One Disaggregation Population

Where a plan benefits more than one disaggregation population (i.e., a group that is mandatorily disaggregated from other participant populations covered by the plan), an employee might be part of two or more disaggregation populations during a single plan year, and accrue benefits with respect to service in each of those disaggregation populations.

This may occur under the following circumstances:

[44] Treas. Reg. §54.4975-11(a)(2).

- A plan covers employees in more than one QSLOB, and an employee shifts between two or more QSLOBs during the plan year;
- A plan covers union and nonunion employees, and an employee is a union employee for part of the year and a nonunion employee for another part of the year; or
- A plan covers the employees of two or more unrelated employers (i.e., a multiple employer plan), and an employee is transferred during the year from one unrelated employer to another, or simultaneously works for two or more unrelated employers during the plan year.

If an employee is part of two or more disaggregation populations during the plan year, in which disaggregated portion of the plan is he or she benefiting for coverage testing?

As a general rule, benefits accrued or allocations made to an employee are provided under the portion of the plan in which the employee is included at the time of the accrual or allocation.[45] That means an employee might be treated as benefiting for coverage purposes with respect to two or more disaggregation populations. Each disaggregated group takes into account only the benefits accrued (or allocations made) to the employee while he or she was a member of that disaggregation population.

Certain Disaggregation Rules Do Not Apply When Performing the Average Benefit Test

When identifying the ABP testing group taken into account for the average benefit percentage test calculation, certain disaggregation rules are ignored. Specifically, the disaggregation rules relating to 401(k) arrangements, 401(m) arrangements and ESOP portions of a plan are not applicable when the ABP is calculated.[46] However, the disaggregation rules pertaining to otherwise excludable employees, QSLOBs, union employees and multiple employer plans are not ignored in calculating the ABP.

EXAMPLE 5-16. Aggregation of 401(k) with Nonelective Contributions to Determine ABP Testing Group. A profit-sharing plan includes a 401(k) arrangement, but not a 401(m). The nonelective contribution portion of the plan and the 401(k) arrangement portion of the plan are tested separately for coverage, pursuant to Treas. Reg. §1.410(b)-7(c). The nonelective contribution portion fails the ratio percentage test. When performing the average benefit test, the nondiscrimination classification test is run separately on the nonelective contribution because of mandatory disaggregation. However, the ABP is calculated by including benefits accrued under the 401(k) arrangement in determining the nonexcludable employees' benefit percentages because the 401(k) arrangement is part of the ABP testing group with respect to the nonelective contribution portion of the plan.

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[45] Treas. Reg. §1.410(b)-7(c)(4)(i)(B).
[46] Treas. Reg. §1.410(b)-7(e).

EXAMPLE 5-17. Union and Nonunion Employees Covered in Same Plan. A profit-sharing plan covers union and nonunion employees. The union and nonunion portions of the plan must be disaggregated for coverage testing purposes. The nonunion portion fails the ratio percentage test. When performing the average benefit test, the nondiscrimination classification test is run separately on the nonelective contribution because of mandatory disaggregation. In addition, the ABP is calculated by disregarding allocations made under the union portion of the plan because disaggregation rules for union and nonunion employees are not ignored to determine the plans in the ABP testing group. Note that the union group will also not be part of the coverage testing group in calculating the ABP for the nonunion portion of the plan, because union employees are excludable employees with respect to nonunion plans.

ELECTIVE 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 and 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 and were ineligible for permissive aggregation. Unlike the other disaggregation rules (except QSLOB testing), disaggregating otherwise excludable employees is elective. The employer may choose to run coverage testing without disaggregating statutory employees and otherwise excludable employees and perform a single coverage test that takes into consideration both groups of employees.

Effect of Plan's Entry Dates on Definition of Otherwise Excludable Employees

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 that is six months from the date on which eligibility requirements are satisfied. A plan may state the entry date assumption that it is using if otherwise excludable employees are being disaggregated for coverage testing purposes. However, this type of provision is rare, particularly since the regulations do not require that the plan specifically permit this testing option. If the plan uses entry dates that would make an employee a participant sooner than the statutory 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 guidance.

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 the date on which eligibility requirements are satisfied 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 if the plan had used the statutory age and service requirements.

Determining the Coverage Testing Group for the Disaggregated Plans

When testing the plan covering otherwise excludable employees, the statutory employees are excluded from the coverage testing group. Also, any employees who fail to meet the age and service requirements imposed by the plan 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 other employee who has satisfied the statutory age and service requirements (and who is, therefore, separately tested), is an excludable employee—that is, not included in the coverage testing group for the disaggregated plan that covers the otherwise excludable employees.

When testing the plan covering the statutory employees, all employees who fail to meet the statutory age and service requirements are excluded from the coverage testing group, which includes the otherwise excludable employees who are eligible for the plan.[47]

Plan Using Two-Year Eligibility Rule

This special testing option that permits disaggregation of otherwise excludable employees 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

[47] Treas. Reg. §1.410(b)-7(a); Treas. Reg. §1.410(b)-6(b)(3).

employees who are eligible for the plan but would be excluded if the plan imposed a two-year eligibility requirement.

Consistency from Year to Year Not Required

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.

If an employer opts to disaggregate one year and not to disaggregate the next year, or vice versa, it could affect the application of the prior year testing method under the ADP test[48] or ACP test[49] if the disaggregation election (or decision not to disaggregate) is made with respect to a 401(k) arrangement or a 401(m) arrangement.

EXAMPLE 5-18. Otherwise Excludable Employees. A profit-sharing plan's eligibility conditions are age 21 and six months of service.

Coverage test run without disaggregating otherwise excludable employees. Suppose the employer does not disaggregate otherwise excludable employees. The plan fails the ratio percentage test, based on the following facts:

[48] IRC §401(k)(3).
[49] IRC §401(m)(2).

(1)	Workforce during plan year	30
(2)	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates	2
(3)	Number of nonbenefiting employees not included in (2) who terminate before year end with 500 or fewer hours of service	0

		HCEs	NHCEs	Total
(4)	Coverage testing group (1) − (2) − (3)	5	22	27
(5)	Employees in the coverage testing group who do not benefit under the plan:			
	Number of employees in (4) who terminate before year end with more than 500 hours of service credited during plan year	0	9	9
(6)	Benefiting group (4) − (5)	5	13	18
(7)	Coverage ratios (6)/(4)	100%	59.09%	
(8)	Ratio percentage (7) for NHCE/(7) for HCE			59.09%

Because the terminated employees included in step (5) were all NHCEs, the plan failed the ratio percentage test.

Coverage test run by disaggregating otherwise excludable employees. Suppose most of those terminations were in the otherwise excludable employee group and all the HCEs satisfy the statutory one year of service requirement. By disaggregating the otherwise excludable employees for the coverage test, the plan would pass coverage. Here is how the coverage test would look if otherwise excludable employees were disaggregated from statutory employees.

Coverage Testing (A): Statutory Employees		
(1)	Workforce during plan year	30
(2)	Number of employees who do not satisfy age/service as of the January 1 or July 1 entry dates	
	(a) Number of employees who do not satisfy age/service as of the January 1 or July 1entry dates	2
	(b) Number of employees (other than those included in (a)) who would not be eligible for the plan as of the January 1 or July 1 entry dates if the service requirement were one year (i.e., the otherwise excludable employees)	9
(3)	Number of nonbenefiting employees not included in (2) who terminate before year end with 500 or fewer hours of service	
	Statutory employees (not included in (2)(a) or (2)(b):	0
	Otherwise excludable employees (included in (2)(b):	1

		HCEs	NHCEs	Total
(4)	Coverage testing group (1) − (2) − (3)	5	14	19
(5)	Employees in the coverage testing group who do not benefit under the plan:			
	Number of employees in (4) who terminate before year end with more than 500 hours of service credited during plan year	0	4	4
(6)	Benefiting group (4) − (5)	5	10	15
(7)	Coverage ratios (6)/(4)	100%	71.43%	
(8)	Ratio percentage (7) for NHCE/(7) for HCE			71.43%

Coverage Testing (B): Statutory Employees				
		HCEs	NHCEs	Total
(IV)	Coverage testing group: Otherwise excludable employees (2)(b) – (3)(b)	0	8	8
(V)	Employees in the coverage testing group:			
	Number of employees in (4) who terminate before year end with more than 500 hours of service credited during plan year	0	5	5
(VI)	Benefiting group (4) − (5)	0	3	3
(VII)	Coverage ratios (6)/(4)	N/A	37.5%	
(VIII)	Ratio percentage (7) for NHCE/(7) for HCE			N/A

The coverage ratio for the otherwise excludable employees (step (VIII)) is not computed because no HCEs are covered. When no HCEs benefit under a plan (or a disaggregated plan), the plan is deemed to satisfy coverage.

Otherwise Excludable Employee Disaggregation Is Separately Elected for Each Disaggregated Portion of Plan

If a plan is disaggregated into separate plans for coverage testing under other disaggregation rules, the otherwise excludable employee disaggregation election applies separately to each of those disaggregated portions of the plan.

EXAMPLE 5-19. 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 decision to use 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).[50] However, the employer does not elect to disaggregate otherwise excludable employees for the nonelective contribution component.

[50] IRC §401(k)(3)(F); IRC §401(m)(5)(C).

There will be five coverage tests performed with respect to the 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 employees under Treas. Reg. §1.410(b)-6(b)(1). For the 401(k) 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.

EXAMPLE 5-20. ESOP with Non-ESOP Component. An employer maintains a profit-sharing plan that includes an ESOP component. For coverage testing, the plan consists of two mandatorily disaggregated components, the ESOP component and the non-ESOP component.[51] The employer is permitted to elect otherwise excludable employee disaggregation for one of the components and not for the other. Of course, the employer also could elect otherwise excludable employee disaggregation for both components or not elect this disaggregation for either component.

Disaggregation Applies to Average Benefit Test

If the employer is using the average benefit test for a plan (or portion of a plan) covering otherwise excludable employees, only the otherwise excludable employees are included in the ABP calculation. Similarly, if the employer is using the average benefit test for a plan (or portion of a plan) covering the statutory employees, only the statutory employees are included in the ABP calculation. Therefore, the ABP testing group for the otherwise excludable employees excludes the plans (or the portions of plans) that cover statutory employees, and the ABP testing group for the statutory employees excludes the plans (or the portions of plans) that cover otherwise excludable employees.[52] In applying this rule, Treas. Reg. §1.410(b)-7(e)(1) determines the plans that could be permissively aggregated by disregarding the mandatory disaggregation rules under Treas. Reg. §1.410(b)-7(c)(1) and (2), but does not disregard the otherwise excludable employee disaggregation under Treas. Reg. §1.401(b)-7(c)(3).

Whether to include otherwise excludable employees in the ABP testing group should be determined with reference to the plan (or disaggregated portion of a plan) that is relying on the average benefit test.[53] This issue arises where, for example, the employer disaggregates otherwise

[51] Treas. Reg. §1.410(b)-7(c)(2).
[52] Treas. Reg. §1.410(b)-7(e)(1), which provides that the ABP testing group includes only plans that could be permissively aggregated.
[53] Treas. Reg. §1.410(b)-7(a).

excludable employees with respect to a plan (or a disaggregated portion of a plan), but does not do so with respect to another plan (or disaggregated portion of a plan). Consider the following example.

EXAMPLE 5-21. Otherwise Excludable Employees Disaggregated for Nonelective Contributions but Not 401(k) Arrangement. A 401(k) plan also provides for discretionary employer nonelective contributions. There is a last day employment condition for allocation of the nonelective contributions. There is a three-month eligibility requirement that applies to both components. Due to a significant number of employment terminations during the plan year, the nonelective contribution component is unable to pass coverage when statutory employees and otherwise excludable employees are not disaggregated. The employer elects to disaggregate statutory employees and otherwise excludable employees for purposes of applying the coverage tests to the nonelective contribution component of the plan. The otherwise excludable employees are all NHCEs, so no coverage test is necessary for that group. When the coverage test is applied separately to the statutory employees, the nonelective contribution component of the plan passes the nondiscriminatory classification test under Treas. Reg. §1.410(b)-4. When the ABP test is applied, the ABP testing group includes the 401(k) arrangement because the 401(k) disaggregation rule does not apply in identifying the ABP testing group.[54]

To illustrate, consider the example in the prior paragraph. Under this argument, the nonelective contributions for the statutory employees would be tested for nondiscriminatory classification test purposes without regard to the otherwise excludable employees. However, when the ABP test is performed, the otherwise excludable employees are included because the 401(k) arrangement did not disaggregate those employees in performing the coverage tests. Because the otherwise excludable employees are included in the ABP test, the elective contributions and nonelective contributions allocated to those employees are taken into account.

Effect of Exclusion of Employment Classifications from the Plan

If the plan excludes one or more employment classifications, separate determinations are made of who is benefiting under the otherwise excludable employee component and who is benefiting under the statutory employee component.

EXAMPLE 5-22. A 401(k) Plan has a Three-Month Eligibility Rule, but Also Excludes Hourly Paid Employees. The employer is electing to disaggregate otherwise excludable employees to satisfy the coverage test for the 401(k) arrangement. You have the following data for the plan year:

[54] Treas. Reg. §1.410(b)-7(e)(1).

		Statutory Employees	Otherwise Excludable Employees
(a)	Total (salaried & hourly)	100 (10 HCEs, 90 NHCEs)	20 (2 HCEs,18 NHCEs) W9
(b)	Salaried only	78 (10 HCEs, 68 NHCEs)	10 (2 HCEs, 8 NHCEs)
(c)	Hourly only	22 (all NHCEs)	10 (all NHCEs)

Assume that the numbers shown in row (a) represent only the nonexcludable employees under Treas. Reg. §1.410(b)-6. In other words, the coverage testing group for statutory employees totals 100, and the coverage testing group for otherwise excludable employees totals 20. When determining the benefiting group for each disaggregated portion of the 401(k) arrangement, the employees in row (c) are not benefiting because they are hourly paid employees and therefore ineligible to make elective deferrals under the 401(k) arrangement. The resulting coverage ratio percentage for the statutory employees is 75.56 percent (75.56 percent of the statutory NHCEs and 100 percent of the statutory HCEs are benefiting under the plan). The resulting coverage ratio percentage for the otherwise excludable employees is 44.44 percent (44.44 percent of the otherwise excludable NHCEs and 100 percent of the otherwise excludable HCEs are benefiting under the plan). The disaggregated portion of the plan covering the statutory employees passes the ratio percentage test. The disaggregated portion of the plan covering the otherwise excludable employees must satisfy the average benefit test in order to pass coverage because the ratio percentage is less than 70 percent. The average benefit test will be performed by treating the statutory employees as excludable employees.

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.

Permissive Aggregation of Plans Maintained by Related Employers

The permissive aggregation rules described in Treas. Reg. §1.410(b)-7(d) may be applied to plans maintained by different related group members in the same manner as they are applied to plans maintained by the same employer.

Remember that plans must have the same plan year to be eligible for permissive aggregation.[55] This issue arises more often in separate plans maintained by related employers than for separate plans maintained by a single company.

TRANSITION PERIOD FOR CERTAIN ACQUISITIONS OR DISPOSITIONS

A controlled group situation can affect coverage testing. Due to mergers, acquisitions, dispositions or spin-offs of companies, the make-up of a controlled group or affiliated service group may change. It is difficult to deal with the coverage changes at the time of a company transaction of this sort. In recognition of the fact that this is a complex time for a company or a group of affiliated companies, Congress provided a safety valve in IRC §410(b)(6)(C). If a plan satisfies coverage at the time of the acquisition or disposition of a related group member, the plan is deemed to meet coverage during a transition period after the transaction.[56] Also, similar treatment is provided with respect to plans in which other business transactions (e.g., acquisition of assets) result in the change of employer for one or more individuals. The transition period begins on the date of the transaction and ends on the last day of the next plan year beginning after the transaction (subject to an earlier ending date in the event of certain changes in the plan).[57]

Regulations Expand Application

The regulations define an acquisition or disposition for IRC §410(b)(6)(C) purposes to include any stock or asset acquisition, merger or other similar transaction that involves a change in employer of the employees of a trade or business.[58] This definition permits use of the coverage transition period where a corporation purchases the assets of another company and acquires the employees of that company. Following the purchase, there is still only one company, so a new controlled group member has not been added. Yet, the regulations permit use of the transition period under this type of transaction.

Must Not Have Significant Change in Coverage During Transition Period

One of the more problematic issues with respect to determining if the IRC §410(b)(6)(C) transition period applies is that there can be no significant change in coverage under the plan during the transition period, other than a change directly resulting from the acquisition or disposition.[59] For example, an amendment during the transition period to exclude hourly paid employees would violate this rule because the exclusion of hourly paid employees is not directly related to the acquisition or disposition. If such an amendment occurs, the transition period terminates and the plan must meet the coverage rules immediately.

[55] Treas. Reg. §1.410(b)-7(d)(5).
[56] IRC §410(b)(6)(C).
[57] *Id.*
[58] Treas. Reg. §1.410(b)-2(f).
[59] IRC §410(b)(6)(C)(i)(II).

In regulations, the IRS interpreted the prohibition to include significant changes "in the plan or in the coverage of the plan."[60] This would indicate that many, if not all, amendments to the plan during the transition period may affect the continuation of the transition period. This broadening of the type of amendments that can terminate the transition period continued in a revenue ruling issued in 2004. In that ruling, the IRS stated that an amendment that significantly changed the benefit formula in a defined benefit plan terminated the transition period.[61] As a benefit formula change would not customarily modify the coverage of the plan, the question arises as to what types of plan amendments will affect the transition period. Further, what constitutes a "significant" amendment is unclear. As a result, a plan sponsor must be very careful about how he or she amends the plan when relying on the transition period for coverage purposes. (Also noteworthy is the fact that the revenue ruling asked for public comments on the "significant change" rules, but the IRS has yet to provide additional clarifications.)

The revenue ruling also clarifies that, if the employer sponsors more than one plan, but not all plans are amended, the transition period will be considered to terminate early only for those plans that are amended, and that the termination is prospective only.[62]

Creation of New Subsidiary

The transition relief granted by IRC §410(b)(6)(C) appears to contemplate some form of acquisition from an unrelated entity. The formation of a new subsidiary by a company as part of a business restructuring or an acquisition involving entities that are already part of a related group are probably not covered by the transition rule.

Proper Application of Transition Rule

Because the regulatory guidance on IRC §410(b)(6)(C) is sketchy at best, there are situations that may arise for which the application of the transition rule may not be clear. For example, when there are some changes to the coverage of the plans during the transition rule, it may not be clear whether such changes are sufficiently significant to terminate the transition period. Also, the employer might want to argue that the creation of a new subsidiary is eligible for the transition rule under a given set of circumstances. In the past, the best approach would be to request a determination letter, and include a demonstration of satisfaction with the coverage test as part of the determination letter application. Unfortunately, that option is no longer available due to changes in IRS procedures so it is best to document all rationale and decisions regarding the rules application.

Reliance on Transition Rule Is Optional

The transition rule under IRC §410(b)(6)(C) is optional. The plan sponsor may instead elect to apply the coverage tests during the transition period.[63] Why might an employer elect to apply the coverage tests? One example would be where the employer is unclear whether the plan qualifies for the transition period. By choosing to perform the coverage testing, and demonstrating that the

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[60] Treas. Reg. §1.410(b)-2(f); Rev. Rul. 2004-11.
[61] Rev. Rul. 2004-11, 2004-7 IRB 480.
[62] *Id.*
[63] *Id.*

plan passes, there is a backup position in the event the IRS challenges the plan's reliance on the transition rule.

QSLOBS

An employer may elect to test coverage separately for its qualified separate lines of business (QSLOBs).[64] When applying the coverage tests to a plan maintained by a QSLOB, all employees not included in that QSLOB are excludable employees.[65] 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 above apply.[66] Under QSLOB testing, each QSLOB separately determines its workforce, its coverage testing group (employees of other QSLOBs are excludable employees), its coverage ratio percentage and, if applicable, its ABP. When determining the ABP under the average benefit test, only plans maintained by the QSLOB (and the portion of any plan attributable to that QSLOB, except for a plan described below) are taken into account in the ABP testing group.

Special Rule for Reasonable Classification Test

Under the nondiscriminatory classification test portion of the average benefit test, the plan must demonstrate that the classification of employees covered by the plan is reasonable.[67] A plan that benefits employees of more than one QSLOB may satisfy the reasonable classification test as a whole, rather than on the basis of each disaggregated group. If, before disaggregation, the plan has a reasonable classification, then each disaggregated portion of the plan is deemed to cover a reasonable classification.[68] This rule does not affect computation of the nondiscriminatory classification test and the ABP, which are determined on a disaggregated basis when the plan tests coverage under the QSLOB election.

Application of Permissive Aggregation Rules

Under permissive aggregation, two or more plans are treated as a single plan to pass the ratio percentage test or the nondiscriminatory classification test portion of the average benefit test. If plans are being tested on a QSLOB basis, a QSLOB may use permissive aggregation with respect to two or more plans maintained by that QSLOB but not with plans maintained by other QSLOBs because the QSLOB is required to disaggregate its plans from those maintained by other QSLOBs.[69] However, a plan that the employer elects to test on an employer-wide basis is not eligible for permissive aggregation with a plan that is tested under the QSLOB election.

TESTING CERTAIN PLANS ON EMPLOYER-WIDE BASIS

Normally when an employer elects QSLOB testing, all plans maintained by the employer must be tested on a QSLOB basis, and any plan that covers employees of more than one QSLOB, must be

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[64] Treas. Reg. §1.414(r)-8.
[65] Treas. Reg. §1.410(b)-6(e).
[66] Treas. Reg. §1.410(b)-7(c)(4)(ii)(A).
[67] Treas. Reg. §1.410(b)-4(b).
[68] Treas. Reg. §1.410(b)-7(c)(5).
[69] Treas. Reg. §1.410(b)-7(d)(4).

disaggregated and tested separately for each QSLOB portion of the plan. However, if a plan maintained by the employer covers at least 70 percent of the nonexcludable employees (determined on an employer-wide basis), that plan need not be tested on a QSLOB basis, even if it covers employees of more than one QSLOB.[70]

NO NHCES IN COVERAGE TESTING GROUP

If there are no NHCEs in the coverage testing group, the plan is deemed to meet coverage for the plan year.[71] When there are no NHCEs in the coverage testing group, the need for a nondiscrimination test is also eliminated.

> **EXAMPLE 5-23. No NHCEs.** Corporation X has five employees, two of whom are equal shareholders of Corporation 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 meet the plan's eligibility service requirement.[72] Because the only employees in the coverage testing group for the plan year are HCEs, the plan is deemed to meet coverage.

If there is at least one NHCE in the coverage testing group, this rule does not apply. In Example 5-23, 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.

When plans are permissively aggregated for coverage purposes, the above rule would apply only if 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 meet coverage.

SIMPLIFIED PROCEDURES FOR SUBSTANTIATING COVERAGE

The coverage tests may be burdensome, particularly to a larger employer, because of the employee information needed. The IRS will accept less-than-precise data if the data used is the best data available at a reasonable expense, and there is a high likelihood that the plan would satisfy coverage if precise data were used. The IRS calls this substantiation quality data.[73]

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[70] Treas. Reg. §1.414(r)-1(c)(2).
[71] Treas. Reg. §1.410(b)-2(b)(5).
[72] Treas. Reg. §1.410(b)-6.
[73] Rev. Proc. 93-42, 1993-2 C.B. 540.

Snapshot Testing Date

In the earlier discussion of the coverage testing group in Chapter 6 of *Defined Contribution Plan Series Volume 1: Plan Qualification and Compliance Basics,* we noted the plan may use snapshot testing to identify the employee population for testing purposes. The employer would identify the coverage testing group and the benefiting group on the basis of the employee population on the snapshot testing date.[74] When determining the benefiting group under a plan that imposes a service condition for allocation purposes, must the employer actually determine whether the employee satisfies the service condition? Not necessarily! If the substantiation quality data rule is available, the employer may treat an eligible employee (as of the snapshot testing date) as benefiting under the plan, even if, in reality, the employee does not benefit for the plan year (e.g., the employee terminates employment after the snapshot testing date and does not receive an allocation of employer contributions).

If the employer takes this approach, it must adjust the required ratio percentage by 10 percent (if the allocation requirement includes a last day employment rule) or by 5 percent (if the allocation requirement is based solely on hours of service credited, such as 1,000 hours).

EXAMPLE 5-24. Adjustment of Required Ratio Percentage for Last Day Employment Rule. A profit-sharing plan has a last day employment rule for allocation purposes. The plan excludes hourly paid employees. The employer identifies the coverage testing group as of a January 1 snapshot testing date. Any salaried employee included in the coverage testing group is deemed to be employed on the last day of the plan year for purposes of determining the benefiting group. If the employer is relying on the ratio percentage test, the 70 percent ratio percentage requirement must be adjusted upward by 10 percent to a 77 percent ratio percentage test. That is, the ratio percentage for this plan must be at least 77 percent to pass the ratio percentage test.

Three-Year Testing Cycle

A coverage test performed for a plan year can be relied on for up to two succeeding plan years if the employer reasonably concludes that there has not been any significant change affecting the outcome of the coverage test performed in that prior year.

LEASED EMPLOYEES

IRC §414(n)(3)(B) includes IRC §410 in the list of employee benefit requirements for which a leased employee is treated 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 rule has the following effects:

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[74] *Id.*

- For purposes of applying the coverage tests to a plan maintained by the recipient, the coverage testing group 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 falls into one of the excludable employee categories described in Treas. Reg. §1.410(b)-6.
- 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.[75] Therefore, a leased employee will not be an excludable employee under Treas. Reg. §1.410(b)-6(b)(1) (i.e., employees who fail to satisfy the plan's minimum age and service requirements) unless the plan requires more than one year of service (e.g., a profit-sharing plan that prescribes a two-year eligibility requirement, pursuant to IRC §410(a)(1)(B)) or unless the leased employee fails to meet the minimum age requirement (e.g., age 21) prescribed by the plan. Also, if the plan disaggregates otherwise excludable employees, most leased employees will be statutory employees because of the one-year full-time service rule under IRC §414(n)(2)(B), so the leased employees usually will not be in the disaggregated portion of the plan that covers the otherwise excludable employees.
- If the plan being tested for coverage requires employment on the last day of the plan year or the completion of a minimum number of hours of service (e.g., 1,000 hours) to benefit under the plan (e.g., allocation conditions of this sort under a profit-sharing 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 under Treas. Reg. §1.410(b)-6(f) if he or she has 500 or fewer hours of service with respect to the recipient for that plan year.

How to Take into Account Contributions or Benefits Provided Under Leasing Organization's Plan for Coverage Testing Purposes

IRC §414(n)(1)(B) provides that contributions or benefits provided by the leasing organization that are attributable to service performed for the recipient are treated as provided by the recipient. 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[76] to pass the ratio percentage test or the nondiscriminatory classification test. Permissive aggregation will be available only if the plan is eligible for aggregation with the plan maintained by the recipient.

EXAMPLE 5-25. Leasing Organization Maintains Plan that is Eligible for Permissive Aggregation. Corporation X maintains a profit-sharing plan. The plan covers only the common law employees of Corporation X. There are five

[75] IRC §414(n)(2)(B).
[76] Treas. Reg. §1.410(b)-7(d).

HCEs and eight NHCEs who are common law employees. Corporation X also receives the services of 15 leased employees, all of whom are NHCEs. The leased employees work for Leasing Organization M. Leasing Organization M also maintains a profit-sharing plan which provides the leased employees a 5 percent contribution. Corporation X's 15 leased employees provide all of their services for Corporation X. The 5 percent contribution under Leasing Organization M's plan is treated as provided by Corporation X. Therefore, Corporation X may elect to permissively aggregate the portion of the Leasing Organization M plan that covers the 15 leased employees with Corporation X's profit-sharing plan to determine if Corporation X's plan satisfies coverage. This may be necessary to pass coverage. When testing Corporation X's profit-sharing plan for coverage, the workforce includes 23 NHCEs: eight common law employees and 15 leased employees. If the contributions provided to the leased employees are not included in the coverage test, the profit-sharing plan would be treated as benefiting only 34.78 percent of the NHCEs (i.e., 8/23).

EXAMPLE 5-26. Leasing Organization Maintains a Plan that is Not Eligible for Permissive Aggregation. Let us change the facts of EXAMPLE 5-25. Suppose, instead, that Leasing Organization M's plan is a 401(k) plan under which there are no nonelective contributions made to the plan. A 401(k) arrangement may not be permissively aggregated with a profit-sharing plan to pass coverage because of the mandatory disaggregation rule under Treas. Reg. §1.410(b)-7(c)(1). If the leased employees do not share in allocations under Corporation X's profit-sharing plan, only 34.78 percent of the NHCEs are benefiting under that plan. The elective deferrals the leased employees receive under the leasing organization's plan may not be aggregated with the profit-sharing contributions under Corporation X's plan to enable the profit-sharing plan to pass coverage. The same result occurs if Leasing Organization M's plan provides a matching contribution on the elective deferrals, because matching contributions are part of a 401(m) arrangement, which also cannot be permissively aggregated with a profit-sharing plan.

Same Plan Year Rule for Permissive Aggregation

Treas. Reg. §1.410(b)-7(d)(5) requires that two plans must have the same plan year to be permissively aggregated. Presumably this rule applies to plans maintained by the leasing organization as well. In Example 5-25, if Leasing Organization M's plan has a plan year ending June 30, but Corporation X's plan has a plan year ending December 31, permissive aggregation would not be available to pass coverage. Corporation X may need to adopt a plan that has the same plan year period as Leasing Organization M to pass coverage, or arrange with Leasing Organization M to have Corporation X's leased employees participate in Corporation X's profit-sharing plan, rather than Leasing Organization M's profit-sharing plan. This solution may not be workable if Leasing Organization M must cover these employees for its own plan to satisfy coverage. Remember, a leasing organization may not take credit for contributions provided by the recipient employer. IRC §414(n)(1)(B) applies only to the recipient.

ABP Includes Plans of Leasing Organization that Cover Leased Employees

If the recipient employer's plan is relying on the average benefit test to pass coverage, remember that the ABP is determined with respect to all plans in the ABP testing group.[77] Because contributions or benefits provided by the leasing organization with respect to services performed for the recipient, are treated as provided by the recipient, the ABP testing group would include the leasing organization's plans that cover the recipient's leased employees. For this purpose, the plans do not have to be on the same plan year as they do for permissive aggregation under the ratio percentage test or the nondiscriminatory classification test.[78] Aggregation of all plans to compute the ABP is required even if the plans are not permissively aggregated to pass the nondiscriminatory classification test portion of the average benefit test.

EXAMPLE 5-27. Coverage Testing of Leasing Recipient Plan. Corporation Y maintains a profit-sharing plan that excludes leased employees. The plan benefits ten HCEs and 25 NHCEs. Corporation Y has 30 leased employees, all of whom are NHCEs. To test Corporation Y's profit-sharing plan for coverage, the coverage testing group consists of ten HCEs and 55 NHCEs (25 common law and 30 leased). (We are assuming that there are no common law employees included in the coverage testing group other than those who are benefiting under Corporation Y's profit-sharing plan.) The 30 leased employees get a 3 percent contribution under the leasing organization's plan. Corporation Y does not permissively aggregate the leasing organization's profit-sharing plan with its own profit-sharing plan to compute the coverage ratio of its plan. The resulting coverage ratio percentage is 45.45 percent, because the plan covers 45.45 percent of the NHCEs (25/55, representing the ratio of the 25 common law employees who benefit under the plan over the total number of nonexcludable NHCEs) and 100 percent of the HCEs (10/10). The coverage ratio percentage passes the nondiscriminatory classification test under Treas. Reg. §1.410(b)-4. Because the coverage ratio percentage does not satisfy the 70 percent ratio percentage test, the plan must rely on the average benefit test to pass coverage. The ABP is calculated by taking into account the contributions for the leased employees under the leasing organization's plan.

Corporation Y might take the approach illustrated in this example so that it does not have to take into account the leasing organization's plan to satisfy IRC §401(a)(4) with respect to the profit-sharing plan. Two plans are aggregated for IRC §401(a)(4) purposes only if they are permissively aggregated for purposes of the ratio percentage test or the nondiscriminatory classification test. If the leased employees' plan was permissively aggregated with Corporation Y's profit-sharing plan,

[77] Treas. Reg. §1.410(b)-7(e)(1).
[78] Treas. Reg. §1.410(b)-5(d)(3)(ii).

then the plan would satisfy the ratio percentage test for coverage purposes, but both plans would have to be aggregated for nondiscrimination testing under IRC §401(a)(4).

5.06: Corrective Coverage Failures

For the plan to avoid disqualification, errors must be corrected within the prescribed correction period.

REGULATORY CORRECTION PERIOD

An employer may correct the coverage failure by adopting a corrective amendment up to 9½ months after the close of the plan year. The amendment may cure the coverage defects by expanding the group of NHCEs who benefit under the plan (e.g., eliminate an employment classification exclusion) or by increasing the allocations or accruals for NHCEs who already benefit under the plan.[79] An amendment to expand the group of NHCEs who benefit under the plan is usually designed to enable the plan to pass the ratio test, although it might be done to satisfy the nondiscriminatory classification test portion of the average benefits 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 benefits test.

Make-Up Allocation Required in Defined Contribution Plan

In a defined contribution plan the amendment will require a make-up allocation because amounts already allocated are protected from reduction under IRC §411(d)(6).

Expanding Coverage for 401(k) Plan: Employer Must Make QNECs

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 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.[80]

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.[81]

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

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[79] Treas. Reg. §1.401(a)(4)-11(g). (Note that these regulations are part of the §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, too.)
[80] Treas. Reg. §1.401(a)(4)-11(g)(3)(vii).
[81] Treas. Reg. §1.401(a)(4)-11(g)(3)(vii).

employees to satisfy the nondiscriminatory classification test, but the average benefit percentage is under 70 percent. 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. 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.

Amendment Must Have Substance

Treas. Reg. §1.401(a)(4)-11(g)(4) provides that the 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 (i.e., 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 not be 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 §1.401(a)(4)-11(g).

Retroactive Benefits Must be Provided to a Nondiscriminatory Group

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:

I. Separately satisfy the nondiscrimination testing requirements of IRC §401(a)(4) for the preceding plan year, and

II. Benefit a group of employees that separately satisfy the coverage testing requirements IRC §410(b).[82] 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.

If the purpose of the corrective amendment is to meet 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

[82] Treas. Reg. §1.401(a)(4)-11(g)(3)(v)(A).

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 meet 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 Employee Plans Compliance Resolution System (EPCRS). The Voluntary Correction Program (VCP) submission procedures under EPCRS must be used for the voluntary correction of Demographic Failures. The Self-Correction Program (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.

5.07: Review of Key Concepts

- What are the tests that may be used to pass the coverage requirements?
- Describe the components of the average benefit test.
- Describe the components of the nondiscriminatory classification test and the average benefit percentage test.
- What is meant by permissive aggregation? What types of plans may or may not be permissively aggregated? When might plans be permissively aggregated?
- What is meant by mandatory disaggregation? When does mandatory disaggregation apply?
- Define the terms *otherwise excludable employee* and *statutory employee*. Describe how these employees impact coverage testing.
- What effect does aggregation and disaggregation for coverage testing have on nondiscrimination testing?
- How are leased employees treated for coverage testing?
- Describe how mergers, acquisitions and spin-offs affect coverage testing.
- Describe corrective actions that can be taken when a plan does not satisfy the coverage requirements.

5.08: For Practice – True or False

1. To be excludable under the annual coverage testing method, an employee must be excludable for the entire plan year.

2. A plan passes the nondiscriminatory classification test if it passes either the reasonable classification test or the nondiscriminatory classification ratio test.

3. A plan with an NHCE concentration percentage of 70 percent will have a higher safe harbor percentage than a plan with an NHCE concentration percentage of 80 percent.

4. A plan with a coverage ratio percentage that is less than the safe harbor percentage fails the nondiscriminatory classification ratio test.
5. When calculating the ABP, both employer contributions and elective deferrals are included.
6. Permissive aggregation might be used when one plan fails coverage on its own but could pass when aggregated with another plan.
7. If an employee is part of two or more disaggregated groups during a plan year, each group must take into account all allocations made to the employee's account during the plan year.
8. A plan must satisfy either the nondiscriminatory classification test or the ABP test to satisfy the average benefit test.
9. If NHCEs are excluded from the plan, the plan is deemed to satisfy coverage requirements.
10. Leased employees are part of the recipient employer's workforce for coverage testing purposes.

5.09: Sample Test Questions

1. All of the following are reasonable classifications with respect to the average benefit test, EXCEPT:

   A. Hourly paid employees

   B. Salary paid employees

   C. Janitors

   D. Employees named Joe Smith

   E. Employees working in Maryland

2. All of the following statements regarding the ABP test are TRUE, EXCEPT:

   A. The NHCE actual benefit percentage is the average of the employee benefit percentages for each NHCE in the coverage testing group.

   B. Only employees who are benefiting are considered when determining the employee benefit percentages.

   C. Elective deferrals are considered employer contributions and are, thus, included when determining employee benefit percentages.

   D. The employee benefit percentages may be determined based on allocation rates or benefit rates.

   E. Compensation used to determine employee benefit percentages must satisfy IRC §414(s).

3. Based on the following information, determine the minimum number of NHCEs that must benefit in order for the plan to pass the nondiscriminatory classification ratio test.

- HCEs benefit under the plan.
- The classification of covered employee is considered to be nondiscriminatory under the relevant facts and circumstances.
- The safe harbor percentage is 38.75 if the NHCE concentration percentage is 75 percent.
- The unsafe harbor percentage is 28.75 if the NHCE concentration percentage is 75 percent.
- The safe harbor percentage is 35.00 if the NHCE concentration percentage is 80 percent.
- The unsafe harbor percentage is 25.00 if the NHCE concentration percentage is 80 percent.

	HCEs	**NHCEs**	**Total**
Total employees	20	80	100
Excludable employees	0	20	20

A. 15

B. 18

C. 20

D. 21

E. 24

4. All of the following statements regarding permissive aggregation for coverage testing are TRUE, EXCEPT:

A. Plans must have the same plan year to be permissively aggregated.

B. A plan may not be included in more than one group of aggregated plans for coverage testing purposes.

C. A qualified plan under IRC §401(a) is not allowed to take into account a SEP to demonstrate that it passes coverage.

D. An employee must meet the minimum age and service requirements for all plans in a permissively aggregated group to be considered a nonexcludable employee.

E. Plans that are permissively aggregated for coverage must be aggregated for nondiscrimination purposes.

5. Based on the following information, determine the maximum number of HCEs that may benefit to pass the ABP test.

- The coverage testing group consists of 70 NHCEs and 30 HCEs.

- Of the 70 NHCEs, 50 have a benefit percentage of 9 percent, ten have a benefit percentage of 4 percent and the other ten do not benefit under the plan.
- Each HCE either has a benefit percentage of 15 percent or does not benefit under the plan.

  A. 10

  B. 12

  C. 20

  D. 24

  E. 30

6. All of the following statements regarding testing otherwise excludable employees separately for coverage purposes are TRUE, EXCEPT:

   A. Separate testing may be done on a year-to-year basis.

   B. If the average benefit test is used for statutory employees, it must also be used for the otherwise excludable employees.

   C. Employees with more than one year of service are not considered otherwise excludable employees in plans with a two-year eligibility condition, unless they are not age 21.

   D. The 401(k) component of the plan may use the otherwise excludable option even if the 401(m) component of the plan does not.

   E. Plans that use the otherwise excludable option for coverage purposes must also use it for nondiscrimination testing.

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

5.10: Solutions to True or False Questions

1. True.
2. False. To pass the nondiscriminatory classification test, a plan must pass both the reasonable classification test and the nondiscriminatory classification ratio test.
3. True.
4. False. This type of plan could still pass the nondiscriminatory classification test if the coverage ratio percentage satisfies the unsafe harbor percentage and the plan passes the facts and circumstances test.
5. True.
6. True.
7. False. Each disaggregated group generally takes into account only benefits accrued or allocations made while the employee is a member of that group.
8. False. A plan must satisfy both of these tests in order to pass the average benefit test.
9. False. If there are no NHCEs in the coverage testing group, the plan is deemed to satisfy coverage requirements. This is different from excluding NHCEs from participating in the plan altogether.
10. True

5.11: Solutions to Sample Test Questions

1. The answer is **D**. Naming individual employees is not a reasonable classification for purposes of the average benefit test.
2. The answer to this question is **B**. All employees in the coverage testing group are considered, not just those that are benefiting.
3. The answer is **B**. The NHCE concentration percentage is the ratio of the number of nonexcludable NHCEs to the total number of nonexcludable employees (60/80 = 75 percent). Since the classification of covered employees is nondiscriminatory under the facts and circumstances, the plan need only satisfy the unsafe harbor percentage of 28.75 percent. Therefore, at least 28.75 percent of the 60 NHCEs must benefit under the plan.
4. The answer is **D**. If the plans being aggregated have different age and/or service requirements, the excludable employees are determined based on the lowest age and service requirement.
5. The answer is **C**. The NHCE benefit percentage is [(50 x 9%) + (10 x 4%) + (10 x 0%)] / 70 = 7%. The NHCE benefit percentage must be no less than 70% of the HCE benefit percentage. Therefore, the maximum HCE benefit percentage is 10%. The aggregate benefit percentage for all 30 HCEs cannot exceed 10% x 30 = 300%. Thus, the maximum number of HCEs that may benefit is 300% / 15% = 20.

6. The answer is **B**. Statutory employees may be tested using the ratio percentage test while otherwise excludable employees may be tested using the average benefit test and vice versa.

5.12: Appendix A: Average Benefit Test and Special Rules

Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	Midpoint Between Safe Harbor and Unsafe Harbor
0 - 60	50.00	40.00	45.00
61	49.25	39.25	44.25
62	48.50	38.50	43.50
63	47.75	37.75	42.75
64	47.00	37.00	42.00
65	46.25	36.25	41.25
66	45.50	35.50	40.50
67	44.75	34.75	39.75
68	44.00	34.00	39.00
69	43.25	33.25	38.25
70	42.50	32.50	37.50
71	41.75	31.75	36.75
72	41.00	31.00	36.00
73	40.25	30.25	35.25
74	39.50	29.50	34.50
75	38.75	28.75	33.75
76	38.00	28.00	33.00
77	37.25	27.25	32.25
78	36.50	26.50	31.50
79	35.75	25.75	30.75
80	35.00	25.00	30.00
81	34.25	24.25	29.25
82	33.50	23.50	28.50
83	32.75	22.75	27.75
84	32.00	22.00	27.00
85	31.25	21.25	26.25
86	30.50	20.00	25.25

Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	Midpoint Between Safe Harbor and Unsafe Harbor
87	29.75	20.00	24.88
88	29.00	20.00	24.50
89	28.25	20.00	24.13
90	27.50	20.00	23.75
91	26.75	20.00	23.38
92	26.00	20.00	23.00
93	25.25	20.00	22.63
94	24.50	20.00	22.25
95	23.75	20.00	21.88
81	34.25	24.25	29.25
82	33.50	23.50	28.50
83	32.75	22.75	27.75
84	32.00	22.00	27.00
85	31.25	21.25	26.25
86	30.50	20.00	25.25
87	29.75	20.00	24.88
88	29.00	20.00	24.50
89	28.25	20.00	24.13
90	27.50	20.00	23.75
91	26.75	20.00	23.38
92	26.00	20.00	23.00
93	25.25	20.00	22.63
94	24.50	20.00	22.25
95	23.75	20.00	21.88
96	23.00	20.00	21.50
97	22.25	20.00	21.13
98	21.50	20.00	20.75
99	20.75	20.00	20.38

CHAPTER 6:

NONDISCRIMINATION

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6.01: Key Terms

- Accrued-to-date method
- Age-based allocation plan
- Allocation rate
- Ancillary benefits
- Benefits, rights and features
- Broadly available allocation
- Cross-testing
- Current availability test
- Current year method
- Design-based safe harbor
- Effective availability test
- Equivalent benefit accrual rate (EBAR)
- Gateway contribution test
- Gateway test
- General nondiscrimination testing
- Mandatory disaggregation
- Nondesign-based safe harbor
- Normalizing benefits
- Optional form of benefit
- Permissive aggregation
- Restructuring
- Uniform points plan
- Universal availability rule

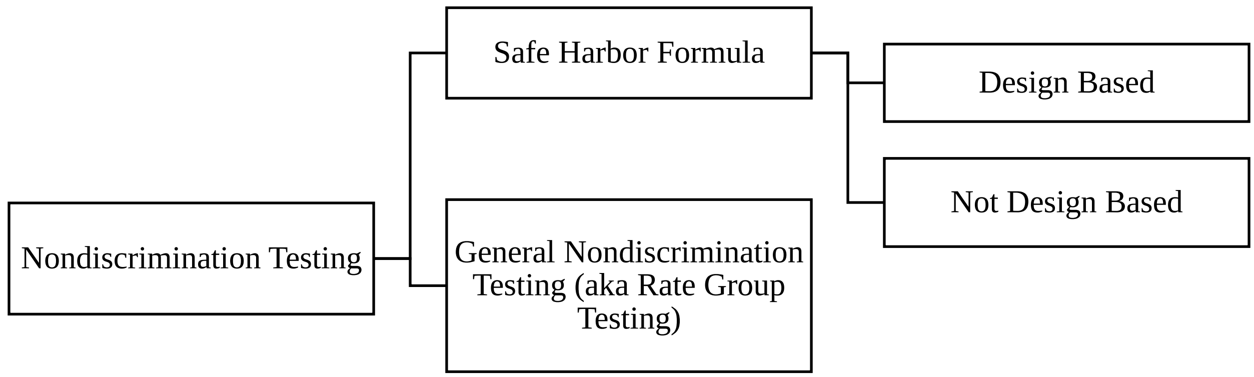
6.02: Introduction

In the previous chapter, we discussed the intricacies of evaluating a plan's compliance with the coverage rules of the Internal Revenue Code (IRC). The basis of those provisions is that there is a relatively easy numeric test that may be passed. If the plan is unable to pass that test, there are a myriad of other possible means of meeting the coverage rules, including permissive aggregation, mandatory disaggregation, and the use of QSLOBs. If the plan cannot pass the basic numeric test after making use of those alternatives, the plan administrator may need to employ the most complex alternative of all: average benefit testing.

This structure gives a sponsor significant flexibility in designing the coverage of employees in the company's plans. This choice between an easy, less flexible alternative and a more complex, but adaptable, alternative is repeated in several other IRC sections, including IRC §401(a)(4), which covers the nondiscrimination rules. We also saw this statutory and regulatory structure with regard to compensation in Chapter 4.

Under the nondiscrimination rules, plan sponsors have two choices:

1. Design a plan using a safe harbor formula. Under a safe harbor formula, the allocation is deemed to be nondiscriminatory, so no further testing is required. For example, a defined contribution plan that provides for pro rata allocations of plan contributions based on compensation is deemed to be nondiscriminatory under the safe harbor rules. Because of the free pass given to plans that fall within the safe harbor rules, the options are not very broad.
2. Structure the plan in a manner outside the safe harbor. If the plan sponsor chooses this option, it must then demonstrate that its alternative structure is not discriminatory by having the plan pass nondiscrimination testing as outlined in the IRC §401(a)(4) regulations.



6.03: Safe Harbor Defined Contribution Plans

From a plan administration standpoint, the least burdensome way to satisfy IRC §401(a)(4) is to use a safe harbor approach. A safe harbor plan can be design-based or nondesign-based. 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 expensive to administer but may be more costly to the employer in terms of the level of contributions provided to its employees.

DESIGN-BASED SAFE HARBOR

A design-based safe harbor plan is deemed to provide nondiscriminatory contributions. This is 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 provide a uniform allocation, either as the same percentage of compensation, a dollar amount or same dollar amount for each unit of service.[1] The same allocation formula generally must apply to all eligible employees.

IRC §414(s) Compensation Must Be Used

A plan intended to be a design-based safe harbor plan for purposes of nondiscrimination testing must use a definition of compensation that meets the requirements of IRC §414(s). As discussed in Chapter 4, a compensation definition may either be a safe harbor definition under the IRC §414(s) regulations, or it may be an alternate definition that meets the compensation ratio test.

[1] Treas. Reg. §1.401(a)(4)-2(b)(2).

If a plan's compensation definition qualifies under the §414(s) safe harbor (e.g., IRC §415 compensation), then the contribution allocation will always be a uniform percentage of IRC §414(s) compensation, and the plan can rely on the design-based safe harbor without having to test its definition of compensation. 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). If a modified definition of compensation 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.

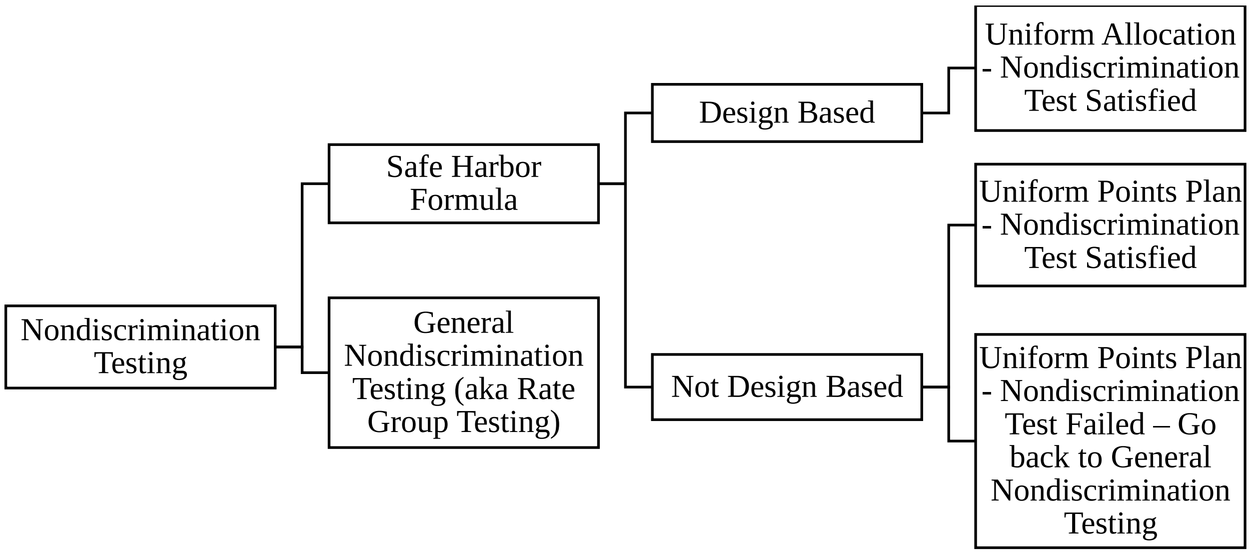
The compensation ratio test must be performed on an annual basis if a modified compensation definition is used for allocation purposes and the plan is intended to satisfy the nondiscrimination test based on the design-based safe harbor rule. Changes in demographics or compensation practices can affect whether the compensation ratio test is satisfied in a particular year. The plan is a safe harbor plan only in those years in which the compensation definition satisfies IRC §414(s).

In the past, if there was a question as to whether a modified definition of IRC §414(s) compensation was nondiscriminatory, a determination letter could be requested from the Internal Revenue Service (IRS) to determine whether IRC §414(s) was satisfied. The IRS discontinued their determination letter review option in regard to compensation, effective February 1, 2012.

NONDESIGN-BASED SAFE HARBOR

There is only one type of defined contribution plan that is a nondesign-based safe harbor plan: the **uniform points plan**.[2] This plan design requires annual testing of the contributions to show that IRC §401(a)(4) is satisfied, but the testing method is simpler than the general testing method described below. If the plan fails the nondesign-based safe harbor test, general testing will have to be used to show IRC §401(a)(4) is satisfied.

[2] Treas. Reg. §1.401(a)(4)-2(b)(3).



CERTAIN PLAN PROVISIONS WILL NOT AFFECT RELIANCE ON IRC §401(A)(4) SAFE HARBORS

There are certain provisions that may be included 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 to not be uniform or a participant's points to not be credited on a uniform basis. 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, the participant’s compensation measurement period for that plan 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.[3]

Certain Conditions on Allocations

A participant's right to share in the allocation may have a condition of employment on the last day of the plan year and/ or completion of a minimum number of hours of service (not to exceed 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 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 from these allocation rules results in a nonuniform application of these conditions, does not cause the plan to fail the safe harbor test.[4] Remember, however, that a

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[3] Treas. Reg. §1.401(a)(4)-2(b)(4)(ii).
[4] Treas. Reg. §1.401(a)(4)-2(b)(4)(iii).

participant's failure to share in the allocation may affect whether the plan passes coverage under IRC §410(b).

Limits on Allocations

A participant's allocation can be limited to a specified dollar amount or percentage of plan year compensation without violating the safe harbor.[5] A safe harbor plan also may limit the dollar amount of plan year compensation taken into account. The IRC §415 limitation on annual additions is an example of such limits, but the plan 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. IRC §401(a)(17) sets a mandatory limit on compensation, but the plan may provide for a lesser dollar limit.

Lower Allocations for HCEs

Any plan provision that results in a lower allocation for one or more highly compensated employees (HCEs) does not affect the plan's status as a safe harbor plan, even though such a provision could prevent allocation uniformity.[6]

Multiple Formulas

The trickiest exception to the uniformity requirement 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 the general testing method. The two formulas may be mutually exclusive alternatives (i.e., the employee receives the greater of the allocation under the two formulas) or the participant may receive the sum of the allocations under the two formulas.[7]

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 condition under Treas. Reg. §1.416-1, M-10 (i.e., the last day employment rule) may be applied to the top-heavy formula without violating the same terms requirement, even if the same allocation conditions are not applied to the regular formula.[8]

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 the employee's allocation is determined solely with reference to

[5] Treas. Reg. §1.401(a)(4)-2(b)(4)(iv).
[6] Treas. Reg. §1.401(a)(4)-2(b)(4)(v).
[7] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi).
[8] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(3).

the top-heavy formula.[9] This is a troublesome requirement and is likely to result in compliance problems for certain plans.

This rule is applied solely for the purpose 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).

Related Employers Maintaining a Single Plan – Separate Contribution or Allocation Formulas

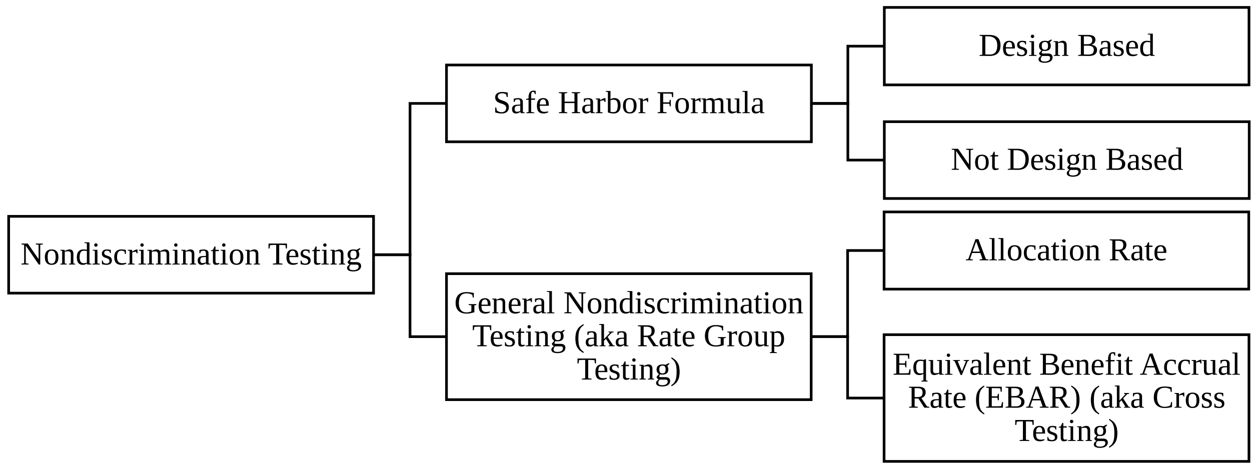
If a plan is maintained by more than one related employer (i.e., a controlled group of businesses under IRC §414(b) or (c), or an affiliated service group under IRC §414(m)), the plan might provide for separate contribution and/or allocation formulas for the participants employed by each participating employer. Such a plan would fail to be a safe harbor plan, because the multiple formulas do not apply uniformly to all participants.

6.04: General Testing for Defined Contribution Plans

WHAT IS GENERAL TESTING?

A defined contribution plan is subject to general testing if it does not fit into one of the safe harbor categories described in the prior section. In simplest terms, **general nondiscrimination testing** is a method of showing that plan allocations or plan benefits are nondiscriminatory by separately analyzing various groups of employees, called rate groups. Each rate group passes this nondiscrimination test if it can satisfy one of the coverage tests under IRC §410(b).

[9] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(3).



The general testing rules under IRC §401(a)(4) are mathematical; providing no room for a facts-and-circumstances test under which a plan that fails the mathematical tests can argue that it is, nonetheless, nondiscriminatory. However, an internal directive at the IRS raised a subjective "discriminatory intent" concept as an overlay on the mathematical rules. The directive points to Treas. Reg. §1.401(a)(4)-(1)(c)(2), sometimes referred to as the anti-abuse regulation, which provides that the nondiscrimination testing provisions under the 401(a)(4) regulations must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of HCEs. Thus, a plan which uses plan formulas and/or hiring practices to provide substantial amounts to HCEs while severely limiting amounts payable to nonhighly compensated employees by targeting coverage to nonhighly compensated employees with short periods of service does not satisfy the nondiscrimination rules of section 401(a)(4) or the regulations.

Although follow-up discussions with the IRS indicate that the directive was too broadly applied by IRS agents when it was issued and later restricted to situations in which abuse was clear, the existence of the directive created uncertainty in the testing area and unwarranted challenges in determination letter application reviews and plan examinations.

DETERMINING RATE GROUPS

To determine rate groups, a defined contribution plan first must express each participant's allocation of employer contributions and forfeitures as an allocation rate or an **equivalent benefit accrual rate** (EBAR). When allocation rates are determined, only the contributions and forfeitures allocated for the current plan year are taken into account, including those allocated to defined contribution plans subject to IRC §412. However, when EBARs are determined, the calculation may take into account contributions and forfeitures allocated for prior years. If the participant's allocation is limited by IRC §415, the reduced allocation is used to compute the allocation rate or EBAR, not the allocation the participant would have received if IRC §415 were disregarded. When an allocation rate or EBAR is expressed as a percentage of compensation, compensation taken into account may not exceed the dollar limit under IRC §401(a)(17).

A few preliminary points to keep in mind (which will all be discussed in this chapter later in detail):

- ***Consistency Required***. The same method of expressing rates must be used for all participants. In other words, the plan cannot express some allocations as allocation rates and others as EBARs.[10]
- ***Cross-testing***. A defined contribution plan typically uses allocation rates for IRC §401(a)(4) testing. When EBARs are used, the testing method is known as cross-testing because it is analyzing the benefit that would be generated from the allocation, as if the plan were a defined benefit plan. Similarly, this concept can be applied to test a defined benefit plan on the basis of allocation rates. Pre-approved plans may include allocation formulas that rely on cross-testing.
- ***401(k) Deferrals and Matching Contributions are Disregarded in Determining Rate Groups***. Although 401(k) deferrals are technically treated as employer contributions,[11] the determination of allocation rates or EBARs does not include increases in the account balance attributable to these elective deferrals (i.e., pre-tax elective deferrals, designated Roth contributions, pre-tax catch-up contributions and Roth catch-up contributions). The actual deferral percentage (ADP) test under IRC §401(k) is the exclusive nondiscrimination test for these contributions. Similarly, matching contributions provided by the employer are disregarded in making these determinations because the actual contribution percentage (ACP) test under IRC §401(m) is the exclusive nondiscrimination test for these contributions.[12] But, remember that if all of the rate groups cannot satisfy the ratio percentage test under IRC §410(b), the average benefit test under IRC §410(b) will have to be performed. When performing the average benefit test, there actually will be two sets of allocation rates or two sets of EBARs that need to be calculated. One set will pertain to the nondiscriminatory classification test, and the other set will pertain to the average benefit percentage test. The set of allocation rates or EBARs calculated for the average benefit percentage test will include the elective deferrals (i.e., pre-tax elective contributions and designated Roth contributions) and matching contributions.
- ***Preconditions to Cross-Testing***. A defined contribution plan may not be cross-tested to satisfy IRC §401(a)(4) unless certain preconditions, known as gateway requirements, are satisfied.
- ***ESOPs***. Employee stock ownership plans (ESOPs) may not perform general testing on a benefits basis (i.e., no cross-testing).[13] Thus, the ESOP must use allocation rates to perform general testing.

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[10] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii).
[11] See IRC §402(e)(3).
[12] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii)(B).
[13] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii)(A).

Determining Allocation Rates

Allocation rates can be expressed as dollar amounts or percentages of plan year compensation. Usually, percentages of plan year compensation are used. The percentage is determined by simply dividing the amount of the allocation by the employee's plan year compensation. Plan year compensation is determined in the same manner as discussed under the safe harbor rules, meaning that IRC §414(s) compensation must be used, and compensation must be measured for the plan year (or the portion of the plan year during which the employee is a participant) or for a uniform 12-month period ending in the plan year. The plan will not necessarily use the same definition to allocate employer contributions as it does to determine allocation rates for nondiscrimination testing purposes.

EXAMPLE 6-1. Determination of Allocation Rate in Profit-Sharing Plan. A profit-sharing plan allocates contributions under a pro rata formula based on compensation. The compensation definition excludes overtime. For the plan year, the compensation ratio test under Treas. Reg. §1.414(s)-1(d) is not satisfied, so the plan fails to be a design-based safe harbor for the plan year. Participant K's plan year compensation consists of $25,000 base salary and $10,000 overtime. K’s allocation for the plan year is $2,000, based on K’s salary only. For nondiscrimination testing purposes, K's plan year compensation is her total compensation of $35,000, because the plan's compensation definition does not satisfy IRC §414(s). The compensation for allocation rate purposes must satisfy IRC §414(s). K's allocation rate for general testing purposes is $2,000/$35,000, or 5.71 percent.

EXAMPLE 6-2. Determination of Allocation Rate for Midyear Entrant. Suppose, in the prior example, that K became a participant on the July 1 entry date for the current plan year. K’s plan year compensation can be calculated as IRC §414(s) compensation for K’s period of participation. If K’s plan year compensation, including overtime from July 1 through December 31, is $18,000, K’s allocation rate would be $2,000/$18,000, or 11.11 percent, for general testing purposes.

IRC §401(a)(4) is testing only the increase in the participant's account balance due to the allocation of employer contributions and forfeitures. Accordingly, investment earnings added to the participant's account for the plan year are not included in determining allocation rates.[14]

[14] Treas. Reg. §1.401(a)(4)-2(c)(2)(iii).

Determining Equivalent Benefit Accrual Rates to Test Benefits (Cross-Testing)

EBARs are determined by expressing the allocation of contributions and forfeitures in a defined contribution plan as an annual benefit payable as a single life annuity at the employee's testing age.[15] This process is known as **normalizing the benefit**.[16] The EBARs may be expressed as percentages of average annual compensation (most common) or as dollar amounts. The process of normalizing benefits is based on the principle of the time value of money, which recognizes that a younger participant has more years during which a contribution may grow into a meaningful benefit at retirement than an older participant. Therefore, a contribution for the benefit of a younger individual is more valuable than that same contribution made for the benefit of an older participant. Cross-testing enables the plan to satisfy IRC §401(a)(4) from a different perspective, so that higher contribution rates for older HCEs will not necessarily cause the plan to be discriminatory. This is because the projected benefits of many of the younger employees are much greater in the future, even though their current contribution levels are not as high.

Plan designs that utilize cross-testing are sometimes called new comparability plans. This phrase is a throw-back to a 1982 revenue ruling that interpreted the nondiscrimination rules that were in effect at that time. The 1982 ruling discussed how to perform a comparability analysis, which was somewhat similar to cross-testing. Therefore, when cross-testing was introduced in 1992, many practitioners dubbed the process new comparability.

Testing Age

The testing age is usually the normal retirement age specified in the plan, unless that age is not a uniform normal retirement age. The uniform normal retirement age requirement is satisfied if the same specified age (not to exceed 65) applies to all participants, or if normal retirement age is determined as the later of a specified age (not to exceed 65) or a specified anniversary of plan participation (not to exceed the 5th anniversary of the participant).[17]

The Code provides that the Social Security retirement age (age 67 for employees born after 1954; age 66 for employees born between 1938 and 1954; and age 65 for employees born before 1938) is treated as a uniform retirement age for purposes of IRC §401(a)(4), regardless of whether employees have the same Social Security retirement age.[18] Therefore, the plan may determine EBARs based on a testing age that is defined as the Social Security retirement age. This would result in even smaller actuarial factors, and thus larger EBARs, for younger employees who have later retirement ages. This, in turn, helps a cross-testing analysis because the nonhighly compensated employees (NHCEs) are usually younger on average.

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[15] Treas. Reg. §1.401(a)(4)-8(b).
[16] Treas. Reg. §1.401(a)(4)-12, definition of "normalize."
[17] Treas. Reg. §1.401(a)(4)-12, *testing age* and *uniform normal retirement age* definitions.
[18] IRC §401(a)(5)(F)(i).

However, because amended regulations relating to the use of Social Security retirement age have not been issued, in the past it was recommended that a determination letter be requested that covers the nondiscrimination test if the plan used the Social Security retirement age as the uniform normal retirement age. A favorable letter would provide reliance on this testing methodology, at least for the year in which the submission was made. However, effective February 1, 2012, the IRS discontinued issuing determination letters that considered the nondiscrimination testing requirements.

If the Social Security retirement age is used as the testing age for calculating EBARs, the plan's normal retirement age definition should be amended to provide that, solely for purposes of testing nondiscrimination under IRC §401(a)(4), a participant's normal retirement age is the participant's Social Security retirement age. This will accommodate the requirement in Treas. Reg. §1.401(a)(4)-12 that the testing age relate to the uniform normal retirement age specified in the plan, but will not cause a conflict with the normal retirement age requirements under IRC §411(a)(8) with respect to other qualification requirements.

Measurement Period for Allocations

The measurement period for the allocation may be determined under the **current year method** (i.e., based only on data for the current plan year), or the **accrued-to-date method** (i.e., based on data for the current plan year and all prior years, or prior years beginning after a fresh-start date).[19] A measurement period that includes future years is not permitted when allocations under a defined contribution plan are being normalized into an EBAR.[20]

Current year method. Under the current year method, benefits are being normalized. This normalized amount is the total of employer contributions and forfeitures allocated to the participant's account for the plan year. The employer may elect to include the earnings attributable to the employer contributions and forfeitures allocated to the participant's account for the plan year as part of the normalized amount.[21] Usually, these earnings are disregarded and the normalized benefit is based only on the employer contributions and forfeitures allocated to the participant's account for the plan year.

Accrued-to-date method. Under the accrued-to-date method, the amount to be normalized is the increase in the participant's account balance during the measurement period (as adjusted below), divided by the number of years in the measurement period in which the employee benefited under the plan.[22]

Income, expenses, gains or losses attributable to contributions and forfeitures allocated during the measuring period are taken into account. However, income, expenses, gains or losses

[19] Treas. Reg. §§1.401(a)(4)-8(b)(2) and 1.401(a)(4)-3(d)(1)(iii).
[20] Treas. Reg. §1.401(a)(4)-8(b)(2)(i).
[21] Treas. Reg. §1.401(a)(4)-8(b)(2)(ii)(A).
[22] Treas. Reg. §1.401(a)(4)-8(b)(2)(ii).

attributable to contributions and forfeitures made prior to the beginning of the measuring period are not taken into account.[23]

Any amount that would have been included, but was distributed during the measuring period, must be added back to determine the amount to normalize.

The accrued-to-date approach can sometimes produce better results because significant variations in annual contribution levels can be smoothed out over the measurement period.

Actuarial Assumptions

The normalization of the relevant allocation amount must be based on a standard interest rate and standard mortality table prescribed by Treas. Reg. §1.401(a)(4)-12.[24] The standard interest rate is an amount between 7.5 percent and 8.5 percent.

Average Annual Compensation

Average annual compensation is defined in Treas. Reg. §1.401(a)(4)-3(e)(2). If the measurement period is the current year method, plan year compensation may be substituted for average annual compensation. However, under the accrued-to-date method, average annual compensation must be used. When plan year compensation is used instead of average annual compensation, plan year compensation is determined in the same manner as for safe harbor plans. Plan year compensation may be limited to the portion of the plan year in which the employee is eligible to participate.[25]

Factor Table Included in Appendix A

Appendix A to this chapter includes a factor table that incorporates the normalization principles described above for cross-testing a defined contribution plan. The table is based on an interest rate of 8.5 percent and the UP-1984 mortality table, using a testing age of 65. The table assumes that, at age 65, it costs $7.9486 for each $1 of annual benefit. Use the table in Appendix A as follows:

- ***Determination of Actuarial Factor***. Determine the participant's actuarial factor for the plan year, based on his or her number of years to the plan year in which he or she reaches age 65. The number of years may be determined through the end of the year in which the participant reaches the testing age (65 in the sample table) or through the last day of the year that is nearest to the participant's testing age. For an employee whose testing age is reached in the first half of a plan year, this will result in one less year under the factor table. The Appendix A factors assume that the end of year method is used. However, either approach should be reasonable if applied uniformly to all employees.
- ***Determination of Normalization Factor***. Multiply the actuarial factor determined above by the participant's average annual compensation. This is the normalization factor. The

[23] Treas. Reg. §1.401(a)(4)-8(b)(2)(ii)(A).
[24] Treas. Reg. §1.401(a)(4)-8(b)(2)(ii)(B).
[25] Treas. Reg. §1.401(a)(4)-12, *plan year compensation* definition.

normalization factor represents the present value of an annual benefit equal to 1 percent of compensation, payable at the testing age of 65.

- ***Determination of EBAR***. Divide the allocation being normalized by the normalization factor. The result is the EBAR, expressed as a percentage, because it represents the number of multiples of a 1 percent annual benefit.

If the participant has passed the normal retirement age, use the factor for zero years to normal retirement age. Note that the definition of testing age normally requires the participant's current age to be his or her testing age if the participant has passed normal retirement age. However, Treas. Reg. §1.401(a)(4)-8(b)(1)(ii) provides that the plan does not fail to satisfy nondiscrimination on the basis of EBARs merely because allocations are made at the same rate for employees who are older than their testing age as they are made for employees who are that age. This supports the use of the factor at normal retirement age. Apparently, the Treasury recognizes that the participants who are past normal retirement age will be comprised of a greater percentage of HCEs than the total work force, so use of the normal retirement age factor is unlikely to increase the likelihood of discrimination (i.e., for a participant who is past normal retirement, and more likely to be an HCE, the actuarial factor at the participant's current age would actually be greater than the factor at normal retirement age, resulting in a lower EBAR).[26]

EXAMPLE 6-3. Cross-Testing Example. J and L are participants in a defined contribution plan. Normal retirement age is 65. The following table shows data for the current plan year on J and L.

Participant	Age	PY Compensation	Allocations	Allocation Rate Group
J	45	$100,000	$15,000	15%
L	25	$20,000	$1,000	5%

If the rate group test were being performed using allocation rates, J's rate would be $15,000/$100,000, or 15 percent, and L's rate would be $1,000/$20,000, or 5 percent.

However, the plan is being cross-tested. The EBARs are determined on the basis of the allocation for the current plan year only, so plan year compensation, rather than average annual compensation, can be used to compute the EBARs. The testing age is the normal retirement age of 65. The EBARs are computed as follows:

[26] Treas. Reg. §1.401(a)(4)-12.

	A	B	C	D
Participant	**Years to NRA 64**	**Actuarial Factor from Appendix A**	**Normalization Factor (Col b x PY Compensation)**	**EBAR (Allocation/ Normalization Factor)**
J	20	.015549	1554.9	9.65%
L	40	.003042	60.84	16.44%

o J's actuarial factor from the table in Appendix A is .015549 because J has 20 years to age 65 (i.e., age 65 minus the current age of 45). J's actuarial factor is multiplied by $100,000 (J's plan year compensation) to determine a normalization factor of 1,554.9. J's allocation of $15,000 is divided by 1,554.9, for a result of 9.65. Therefore, J's EBAR is 9.65 percent.

o L's actuarial factor from the table in Appendix A is .003042 because L has 40 years to age 65. L's actuarial factor is multiplied by $20,000 (L's plan year compensation) to determine a normalization factor of 60.84. L's allocation of $1,000 is divided by 60.84 for a result of 16.44 percent.

Although L's allocation represented only 5 percent of L's plan year compensation, which was 10 percentage points less than J's allocation rate, L's EBAR is greater than J's. The reason for this is that L is much younger than J, so L's allocation is projected to accumulate for a longer period of time (40 years vs. 20 years) when converting L's allocation to a benefit at age 65.

Identifying the Rate Groups

Once the allocations are converted into allocation rates or EBARs, the rate groups are then identified by reference to the rate of each HCE. An HCE's rate group includes all employees (HCEs and NHCEs) who have a rate (either allocation rate or EBAR, whichever is being used in the test) equal to or greater than the HCE's rate.

EXAMPLE 6-4. Rate Group Determination. A profit-sharing plan is being tested using allocation rates. There are three HCEs with the following allocation rates: 11 percent (HCE #1), 9 percent (HCE #2), and 5 percent (HCE #3). The plan has three rate groups, one corresponding to each HCE's allocation rate.

o The 11 percent rate group includes HCE #1 and all NHCEs that have an allocation rate equal to or greater than 11 percent.

o The 9 percent rate group includes HCE #1 and HCE #2, because each has an allocation rate equal to or greater than 9 percent, and all NHCEs that have an allocation rate equal to or greater than 9 percent.

o The 5 percent rate group includes all three HCEs and all NHCEs that have an allocation rate equal to or greater than 5 percent.

Suppose, in the prior example, that HCE #2 also has an allocation rate of 11 percent. Now there are only two rate groups to test: the 11 percent rate group (which includes HCE #1 and HCE #2) and the 5 percent rate group (which includes all three HCEs).

EXAMPLE 6-5. Rate Groups for Cross-Tested Plan. Suppose the plan in Example 6-4 is cross tested instead. The allocations would be converted into EBARs for rate group testing purposes. Assume the resulting EBARs for the HCEs are as follows: 6.33 percent (HCE #1), 11.2 percent (HCE #2) and 9.24 percent (HCE #3). There are three rate groups to test, one corresponding to each HCE's EBAR.

o The 11.2 percent rate group includes HCE #2 and all NHCEs with an EBAR equal to or greater than 11.2 percent.

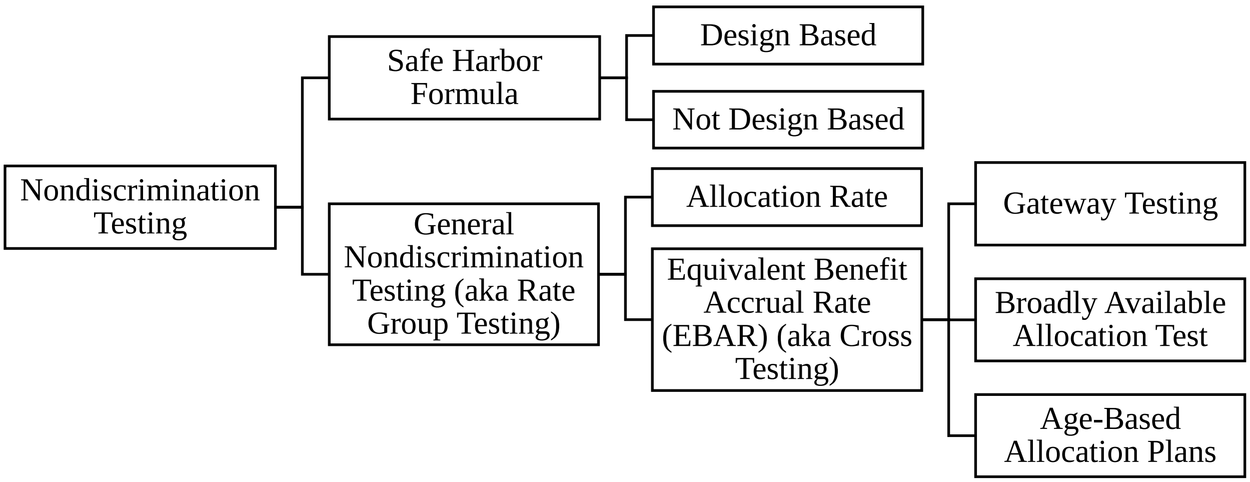
o The 9.24 percent rate group includes HCE #2 and HCE #3 and all NHCEs with an EBAR equal to or greater than 9.24 percent.

o The 6.33 percent rate group includes all three HCEs and all NHCEs with an EBAR equal to or greater than 6.33 percent.

GATEWAY PRECONDITIONS

Treasury Regulations require that defined contribution plans meet a **gateway test** as a precondition to demonstrating satisfaction with IRC §401(a)(4) on a benefits basis (i.e., through cross-testing).[27] This is referred to as a gateway test, because the plan first has to meet this requirement before it can enter into cross-testing. This precondition is the gate that opens up the availability of the cross-testing option. The regulations do not require a plan to pass the gateway test if each allocation rate can meet a broadly available allocation test or the plan has an age-based allocation formula.

[27] Treas. Reg. §§1.401(a)(4)-8(b)(1), 1.401(a)(4)-9(b)(2), and 1.401(a)(4)-9(c)(3), 66 F.R. 34535 (June 29, 2001).



Aggregated plans that consist of at least one defined contribution plan and at least one defined benefit plan (known as DB/DC plans), and are tested on a benefits basis are also subject to these rules.

Remember that the gateway rules do not apply if the defined contribution plan is using general testing on a basis of allocation rates. The gateway requirement only applies when cross-testing is used.

The Gateway Contribution Test

Under the gateway contribution test (designated as the minimum allocation gateway in the regulations), the lowest permissible allocation rate for any NHCE who benefits under the plan is one-third of the highest allocation rate for any HCE who benefits under the plan.[28] This is also referred to as the *one-third test*.

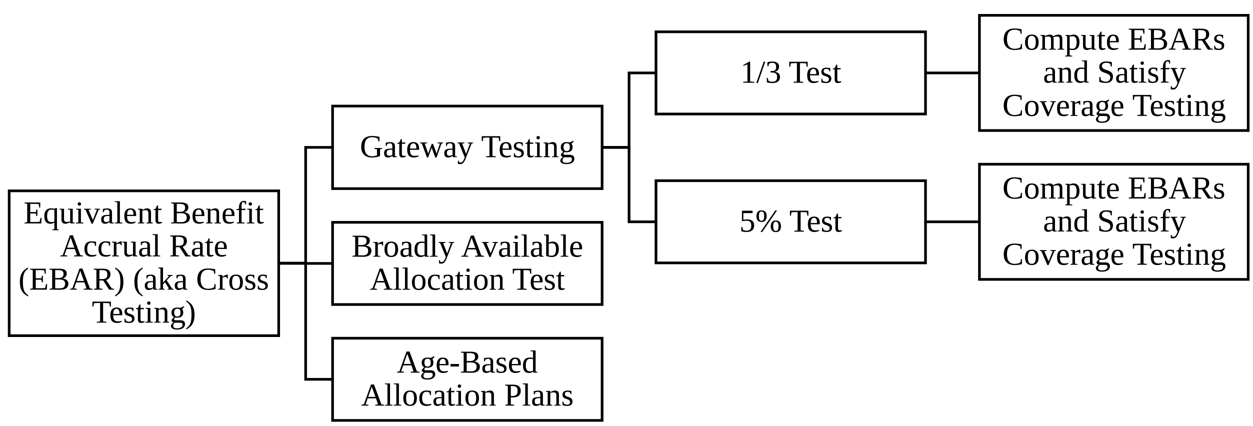
A. **One-third test** – This test is based on the allocation rate. An employee's allocation rate is the percentage obtained by dividing the employee's allocation for the plan year derived from employer contributions (other than matching contributions) and forfeitures by his or her plan year compensation.[29] Plan year compensation, in turn, may be any definition of compensation that satisfies IRC §414(s).

However, if each NHCE receives an allocation that is no less than 5 percent of IRC §415 compensation (i.e., as defined under IRC §415(c)(3)), the gateway is deemed satisfied.[30] This is also referred to as the 5 percent test.

B. **5 percent test** – Plans that provide an allocation to all eligible NHCEs that equals or exceeds 5 percent of compensation will satisfy this gateway automatically (unless

[28] Treas. Reg. §1.401(a)(4)-8(b)(1)(vi)(A).
[29] Treas. Reg. §1.401(a)(4)-2(c)(2).
[30] Treas. Reg. §1.401(a)(4)-8(b)(1)(iv)(B).

compensation other than IRC §415 compensation is used). The 5 percent test must be determined on the basis of IRC §415 compensation. This is the same definition of compensation that is used to determine top-heavy minimum contributions (although partial-year compensation may be used in some cases). Although IRC §415 compensation also satisfies the definition of IRC §414(s) compensation, it is not the only definition of compensation that satisfies IRC §414(s). IRC §415 compensation is more inclusive than other permissible definitions under IRC §414(s) because it encompasses essentially all compensation that constitutes gross income, as well as all pre-tax elective contributions and pre-tax catch-up contributions under IRC §401(k) and IRC §403(b), salary reduction contributions under a cafeteria plan (IRC §125), and salary reduction amounts to purchase qualified transportation fringe benefits (IRC §132(f)(4)). In other words, because a 5 percent allocation rate might be substantially less than the allocation rate given to some or all of the HCEs, the Treasury wants to ensure that the maximum amount of compensation possible is taken into account. Remember that designated Roth contributions and Roth catch-up contributions are after-tax contributions, and therefore not added back when determining the IRC §415 compensation because they are already included in the compensation amount.



The gateway contribution test does not require that the plan document guarantee the minimum contribution. So long as the allocations to all of the NHCEs satisfy the gateway contribution test, the plan may proceed with cross-testing. This is important because most of these plans are profit-sharing plans under which the employer makes discretionary contributions to two or more separate allocation groups. The minimum contribution rate made for any of the allocation groups is determined at the employer's discretion each year. Because of special allocations made under the plan, certain participants may need to have their allocation rate increased for the gateway contribution test to be satisfied. To that extent, the plan design should permit sufficient flexibility so that the employer can satisfy the gateway contribution test through discretionary contributions.

Note that the compensation definition under the 5 percent test is different from the compensation definition for the one-third test.

If the plan uses a non-IRC §415 definition of compensation to allocate employer contributions, the determination of whether the 5 percent test is satisfied will not be as simple as determining whether the participant's allocation rate is at least 5 percent.

EXAMPLE 6-6. Gateway Test. A profit-sharing plan provides for two allocation groups: Group A consists of owners of the company who are all HCEs, and Group B consists of other eligible employees. The employer makes a discretionary contribution for each group. For the plan year, the allocation rate for Group A (using a definition of compensation which satisfies IRC §414(s)) is 20 percent. To pass the gateway contribution test, each NHCE's allocation rate (using the same definition of compensation) must be no less than the lesser of (a) 6.67 percent (i.e., 1/3 of 20 percent) of the compensation used for allocations under the plan, or (b), 5 percent of §415 compensation. Assuming that the §414(s) compensation is a §415 definition of compensation, the company must contribute at least 5 percent of §415 compensation if it is using cross-testing for the plan year.

EXAMPLE 6-7. One-Third Test. Suppose that the sponsor of the plan in the prior example would like to use rate group testing (using EBARs), but only wants to contribute 3 percent of compensation for Group B. Under the regulations, if the employer does not want to increase the contribution rate for Group B above 3 percent, it must limit the contribution rate for Group A to 9 percent (so the one-third test can be satisfied under the gateway test), even if the plan's EBARs could pass the rate group test with a higher contribution rate for Group A.

EXAMPLE 6-8. Plan Uses IRC §415 Compensation for Allocation Purposes. A profit-sharing plan permits an employer to make separate discretionary contributions to identified allocation groups. Within each allocation group, the discretionary contribution made for such a group is allocated under a pro rata allocation formula, based on IRC §415(c)(3) compensation. If the highest HCE allocation rate is less than 15 percent, then the gateway is satisfied so long as the lowest NHCE allocation rate is no less than one-third of that highest HCE allocation rate. If the highest HCE allocation rate is 15 percent or greater, then the gateway is satisfied so long as the lowest NHCE allocation rate is no less than 5 percent. Here it is not necessary to calculate the allocation rates differently for the one-third test and for the 5 percent test because IRC §415 compensation is used to determine allocations.

EXAMPLE 6-9. Plan Uses IRC §414(s) Compensation for Allocation Purposes, but Definition Does Not Satisfy IRC §415(c)(3). Assume the plan described in the prior example does not use IRC §415 compensation for allocation purposes. Instead, the plan modifies the IRC §415 compensation definition to exclude elective deferrals (i.e., salary reduction contributions under a cafeteria plan, elective deferrals under any IRC §401(k) arrangement or IRC §403(b) plan maintained by the employer, and salary reduction to acquire qualified transportation fringe benefits, pursuant to IRC §132(f)(4)). This is an example of a safe harbor definition under IRC §414(s) that does not satisfy the definition of IRC §415 compensation.

To determine whether the one-third test is satisfied, the employer simply identifies whether the allocation rate for each NHCE who benefits under the plan (based on the plan's definition of compensation) is not less than one-third of the highest allocation rate of the HCEs who benefit under the plan.

To determine whether the 5 percent test is satisfied, each NHCE's allocation must be divided by IRC §415 compensation, not by the plan's definition of compensation that was used to actually determine that allocation. If the allocation is at least 5 percent of each participant's §415 compensation, the gateway is met.

EXAMPLE 6-10. Plan Uses Compensation Definition for Allocation Purposes that Satisfies Neither IRC §414(s) Nor IRC §415(c)(3). Let's consider a third possibility for the plan's definition of compensation. Suppose the plan defines compensation by excluding overtime. Further, suppose that the compensation ratio test under Treas. Reg. §1.414(s)-1(d) is not satisfied, so the plan's definition of compensation fails to satisfy IRC §414(s).

In this case, neither the one-third test nor the 5 percent test will be determined using the plan's definition of compensation, even though allocations under the plan are made using that definition. To determine whether the one-third test is satisfied, the allocation rates of all HCEs and NHCEs who benefit under the plan must be calculated by dividing each employee's allocation by a definition of compensation that satisfies IRC §414(s) (not the definition of compensation used by the plan to calculate the amount of each employee's allocation). Any IRC §414(s) compensation definition may be used here, because the plan is not required to state what definition of compensation is used to satisfy the nondiscrimination requirements under IRC §401(a)(4). The one-third test is satisfied if the lowest NHCE allocation rate, as so determined, is not less than one-third of the highest HCE allocation rate.

To determine whether the 5 percent test is satisfied, each NHCE's allocation must be divided by IRC §415 compensation (not the definition of compensation used by the plan to determine allocations). If the allocation rate of each NHCE, using IRC §415 compensation, is at least 5 percent, then the 5 percent test is satisfied.

If neither the one-third test nor the 5 percent test is satisfied, additional employer contributions will have to be made to some or all of the NHCEs, or the plan will not be allowed to be tested on a benefits basis (unless one of the exceptions to the gateway contribution test is satisfied).

If a participant is eligible for only part of the plan year, the participant's compensation may be limited to the period of eligibility under either the one-third test or the 5 percent test.[31]

EXAMPLE 6-11. Use of Partial Compensation for Midyear Entrants. A profit-sharing plan permits an employer to make separate discretionary contributions to identified allocation groups. Within each allocation group, the discretionary contribution made for such group is allocated under a pro rata allocation formula, based on IRC §415 compensation. If a participant is eligible for only part of the plan year (e.g., becoming eligible for the plan as of a mid-year entry date), only compensation from the entry date to the end of the plan year is taken into account.

An NHCE first becomes eligible for the plan as of July 1. The plan year ends December 31. For the plan year, this participant's compensation is taken into account only from July 1 forward. Because the plan defines compensation as IRC §415 compensation for allocation purposes, the 5 percent test is satisfied with respect to this NHCE, if the NHCE's allocation is no less than 5 percent of the NHCE's compensation from July 1 through December 31. If the plan defined compensation a different way, the contribution allocated to this employee would still have to be divided by IRC §415 compensation for the last six months of the plan year to determine if the 5 percent test is satisfied.

Employees Must Receive the Gateway Contribution

Only employees who benefit under the plan for coverage testing purposes, as defined in Treas. Reg. §1.410(b)-3, must receive the gateway contribution. The preamble to the final regulations confirms this. In the preamble, the Treasury notes that, under Treas. Reg. §1.401(a)(4)-12, an employee for nondiscrimination testing purposes is an employee who benefits under the plan. Thus, if the plan requires employment on the last day of the plan year to receive an allocation, employees who fail to benefit because of the last day rule would not have to receive the gateway contribution (assuming the plan otherwise passes coverage).

Remember, the plan being tested consists of all nonelective contributions made by the employer (whether on a required or discretionary basis), unless a portion of the plan is properly disaggregated. The sections below describe those special nonelective contributions that might be made to a plan being cross-tested, which may cause an NHCE to benefit under the plan and thus

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[31] Treas. Reg. §1.401(a)(4)-8(b)(1)(vi)(B).

have to receive the gateway contribution before the plan can satisfy IRC §401(a)(4) on a benefits basis.

Top-heavy minimum contributions. All non-key employees who are participants in a top-heavy plan are required to receive a minimum contribution, pursuant to IRC §416(c), unless the top-heavy minimum is satisfied in a separate plan. A defined contribution plan may require a non-key employee to be employed on the last day of the plan year to qualify for the top-heavy minimum contribution, but may not require a minimum number of hours of service (e.g., 1,000 hours) for the plan year.[32] A non-key employee who is an NHCE and qualifies for a top-heavy minimum contribution, but not for any other nonelective contributions made by the employer for the plan year, is nonetheless required to receive the gateway contribution. If the required gateway exceeds the 3 percent top-heavy minimum contribution, then the additional amount up to the gateway percentage must be extended to the participant, or the plan will be precluded from cross-testing. In other words, if the gateway percentage is 5 percent and the top-heavy minimum is 3 percent, then participants will need to receive an additional 2 percent contribution.

Qualified nonelective contributions (QNECs). If the plan includes a 401(k) arrangement, the employer might decide to make QNECs to satisfy the ADP test or the ACP test. Although QNECs are used to pass the separate nondiscrimination tests, which apply to disaggregated portions of the plan, the QNECs are, nonetheless, part of the plan that consists of the employer's nonelective contributions and must satisfy IRC §401(a)(4) together with the other nonelective contributions. In fact, the plan is required to satisfy IRC §401(a)(4) both with and without the QNECs being taken into account.[33] If the employer is intending to use cross-testing to show that its nonelective contributions satisfy IRC §401(a) (4), an NHCE who benefits only from the QNEC portion of the employer's nonelective contributions to the plan is required to receive the gateway contribution.

Safe harbor contributions under IRC §§401(k)(12) and 401(k)(13). One of the ways a 401(k) arrangement can be exempt from the ADP test is for the plan to satisfy one of the safe harbor 401(k) rules under IRC §§401(k)(12) and 401(k)(13). As a condition for safe harbor treatment, the employer must make a safe harbor contribution for the eligible NHCEs. The safe harbor contribution can be in the form of a matching contribution[34] or a nonelective contribution.[35] If the safe harbor contribution is a match, it will not impact the gateway requirement because matching contributions are not part of the same plan for nondiscrimination testing purposes as the nonelective contributions. On the other hand, if the safe harbor contribution is a nonelective contribution, it does impact the gateway requirement. An eligible NHCE in the 401(k) arrangement must receive the safe harbor nonelective contribution regardless of whether the employee is employed on the last day of the plan year or has earned a minimum number of hours of service for the plan year.[36] An NHCE who qualifies only for the safe harbor nonelective

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[32] Treas. Reg. §1.416-1, M-10.
[33] Treas. Reg. §§1.401(k)-2(a)(6)(ii) and 1.401(m)-2(a)(6)(iii).
[34] IRC §§401(k)(12)(B) and 401(k)(13)(D)(i).
[35] IRC §§401(k)(12)(C) and 401(k)(13)(D)(ii).
[36] IRC §§401(k)(12)(C) and 401(k)(13)(D).

contribution (which is usually 3 percent of compensation) and not for any other portion of the employer's nonelective contribution to the plan, is benefiting under the plan that consists of the employer's nonelective contributions. Therefore, the gateway contribution applies to this participant if the nonelective contributions are going to be cross-tested to satisfy IRC §401(a)(4).

It is important to remember that the top-heavy minimum contribution, the 401(k) safe harbor nonelective contribution and any QNEC amounts all count towards fulfilling the gateway requirement. Therefore, the plan need only provide for an additional contribution equal to the required gateway amount, minus any of these other contributions.

EXAMPLE 6-12. Cross-Testing with Safe Harbor 401(k) Plan. An employer maintains a cross-tested profit-sharing plan with a safe harbor 401(k) arrangement. To satisfy the 401(k) safe harbor, the employer provides the 3 percent safe harbor nonelective contribution (based on IRC §415 compensation). In addition, a discretionary profit-sharing contribution is provided using the plan design described in **Example 6-6** above (Group A consists of owners, Group B consists of all other eligible employees). The 3 percent safe harbor nonelective contribution may be counted in determining whether the allocation to Group B employees satisfies the gateway test. If the employer wants to satisfy the 5 percent gateway test, it simply needs to make sure that the profit-sharing allocation for the eligible NHCEs is at least 2 percent of IRC §415 compensation (because the 3 percent safe harbor nonelective contribution is also based on IRC §415 compensation).

Different Accrual and/or Eligibility Requirements May Expand the Group of NHCEs Who Must Receive the Gateway Contribution

If the employer contributes both safe harbor nonelective contributions and regular nonelective contributions to a safe harbor 401(k) plan, the gateway contribution must be provided to all NHCEs who benefit under the plan. The contribution consists of the total amount of nonelective contributions (safe harbor and regular) made by the employer to the safe harbor 401(k) plan.[37] If there are different accrual and/or eligibility requirements for the safe harbor and regular nonelective contributions, the gateway contribution will need to be provided to any employee who benefits under the safe harbor nonelective contribution but fails to otherwise benefit under the additional nonelective contribution (unless such employee is part of a disaggregated group), or the rate group test may not be performed on a benefits basis.

Other Ways to Provide the Gateway

Restructuring. So long as any of the contributions described above are part of the same plan that includes other non-elective contributions that the employer intends to cross-test, the NHCEs who benefit from such contributions are required to get the gateway contribution. Furthermore, they

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[37] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii) (which is made applicable to the safe harbor nonelective contributions by reason of Section VIII.B. of Notice 98-52) and Treas. Reg. §1.401(a)(4)-1(c)(4)(I).

may not be restructured into a separate component group, in accordance with Treas. Reg. §1.401(a)(4)-9(c). (Restructuring is not the same thing as disaggregation and will be defined later in the chapter. Disaggregation may be a permissible way of eliminating at least some NHCEs from the gateway requirement.)

If there are NHCEs described above who have to receive the gateway, the plan must be designed in a way that gives the employer the authority to increase the contribution made for such employees, at least to the extent necessary to satisfy the gateway. Also, if the plan normally imposes allocation conditions to receive additional employer nonelective contributions, exceptions may be needed for these NHCEs. In many cases, defined contribution plans that are intended to be cross-tested are designed to have separate allocation groups for which the employer makes separate discretionary contributions. The plan design may need to include separate allocation groups for the NHCEs who are described above, but who are not otherwise eligible for employer nonelective contributions, so the employer has the flexibility to contribute at least enough for these employees to satisfy the gateway contribution requirement.

Separate plan option. The contributions described above could be provided in a defined contribution plan that is separate from the plan that includes the employer nonelective contributions intended to be cross-tested. However, before using the separate plan approach, consider whether any NHCEs who benefit in the plan that is being cross-tested are also receiving the contributions described above in the separate plan and whether it is desirable to be able to take into account the contributions for such employees in the IRC §401(a)(4) test performed in the cross-tested plan. If that is the case, the permissive aggregation (defined later in the chapter) of the two plans will be necessary, and the plan is back in the same place, with the permissively aggregated plan treated as a single plan under which all NHCEs who benefit from the nonelective contributions under either plan must receive the gateway contribution.

Aggregation and Disaggregation Rules in Determining Whether Gateway Contribution Test is Satisfied

When determining whether the gateway test has been satisfied, the plan that benefits the HCEs and NHCEs is determined in accordance with the IRC §410(b) coverage rules. Plans that are permissively aggregated under Treas. Reg. §1.410(b)-7(d) are treated as a single plan. Thus, if two defined contribution plans are permissively aggregated for coverage and nondiscrimination testing purposes, employer contributions under both plans are taken into account to determine whether the gateway has been satisfied. Conversely, portions of a plan that are mandatorily disaggregated under Treas. Reg. §1.410(b)-7(c) are not treated as a single plan for purposes of the gateway test. For example, if the employer has elected to disaggregate otherwise excludable employees, the portion of the plan covering the otherwise excludable employees is disaggregated from the portion of the plan covering the statutory employees.[38] If the employer is cross-testing the portion of the plan that covers the statutory employees, the otherwise excludable employees would not have to receive the gateway.

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[38] Treas. Reg. §1.410(b)-7(c)(3).

Sometimes the special nonelective contributions discussed above are provided to employees who normally would not be part of the plan that is subject to cross-testing. For example, suppose the employer is contributing under a cross-tested formula only for employees who satisfy age and service requirements that are different from those imposed for purposes of the 401(k) arrangement under the plan. As a result, some NHCEs who participate only in the 401(k) portion of the plan (and not the portion that allocates the nonelective contributions) are eligible for top-heavy minimum contributions. Therefore, these individuals are allocated a portion of the employer's nonelective contribution to satisfy the top-heavy rules. (A similar situation exists for safe harbor 401(k) plans that are required to give the 3 percent non-elective contribution to all participants eligible to make pre-tax elective contributions.)

Although the 401(k) arrangement itself is disaggregated for coverage and nondiscrimination testing, the top-heavy contribution or safe harbor nonelective contribution allocated to an employee who is eligible solely for the 401(k) arrangement is not part of the disaggregated 401(k) plan. Instead, these contributions are part of the plan that includes the employer's nonelective contributions that are subject to the cross-tested formula and, thus, must be taken into account to determine if the gateway contribution requirement has been satisfied (unless the employee is excludable because of an applicable disaggregation rule, such as the otherwise excludable employee disaggregation).

EXAMPLE 6-13. Statutory Employees who are Eligible Only for 401(k) Portion of Plan. A 401(k) plan maintained by a law firm provides that all employees are immediately eligible for the 401(k) arrangement. However, nonelective contributions are made only for employees who satisfy at least one year of service, are at least 21 years old and are not associates of the law firm (i.e., lawyers who are not shareholders of the law firm). For the current plan year, the plan is top-heavy. As a result, all of the non-key employees employed at the end of the plan year are required to receive an allocation of employer contributions that is no less than 3 percent of compensation. This includes non-key employees with less than one year of service who are eligible only for the 401(k) arrangement, and associates who (as a class) are eligible only for the 401(k) arrangement.

The employer makes a nonelective contribution to satisfy the top-heavy minimum contribution requirement on behalf of any of the non-key employees who are not otherwise eligible for an allocation of nonelective contributions, but are eligible for the 3 percent top-heavy contribution. If the employer wants to cross-test its nonelective contributions to satisfy IRC §401(a)(4), the gateway contribution will have to be satisfied for these non-key employees who also are NHCEs and who otherwise would receive only the top-heavy minimum contributions, unless they are properly disaggregated for testing purposes. The mere fact that these employees are eligible only for the 401(k) portion of the plan does not mean they are disaggregated for this purpose, because it is the nonelective contributions being allocated to them that are being taken into account for IRC §401(a)(4) purposes.

If disaggregation of otherwise excludable employees is elected, then the nonelective contributions made on behalf of such employees would be disregarded for gateway testing. However, any of the associates who are not otherwise excludable employees (for example, associates who have satisfied the statutory age and service requirements) could not be disregarded through disaggregation if they received an allocation of employer nonelective contributions to satisfy the top-heavy rules.

EXAMPLE 6-14. Effect of Matching Contributions Satisfying Top-Heavy Minimum. In the previous example, suppose the plan also provides for matching contributions (i.e., a 401(m) plan). Contributions made under the 401(m) plan are disaggregated from the plan that consists of the employer's nonelective contributions. The plan provides that the top-heavy minimum contribution may be satisfied, in whole or in part, by the matching contributions made on behalf of a non-key employee. Some of the non-key employees who are otherwise not eligible for an allocation of employer non-elective contributions, receive a matching contribution of at least 3 percent of compensation, thereby eliminating the need for the employer to make any nonelective contribution on their behalf to satisfy the top-heavy rules. These employees would not be part of the plan that consists of the employer's nonelective contributions, so the gateway test would not have to be satisfied with respect to these employees.

Matching contributions made by the employer (e.g., matching contributions on 401(k) deferrals) may not be used to satisfy the gateway contribution requirement. This is because matching contributions are part of an IRC §401(m) arrangement, which is not eligible to be aggregated with employer nonelective contributions under a profit-sharing plan to satisfy IRC §401(a)(4). (Section 401(k) and 401(m) arrangements are mandatorily disaggregated from other employer contributions.[39]) In Example 6-14, if non-key employees' matching contributions are less than 3 percent of compensation, the employer must make up the difference in the form of a nonelective contribution to satisfy the top-heavy minimum contribution requirement. Also, the gateway test would have to be satisfied with respect to that employee (if he or she is an NHCE), and the matching contribution could not be considered to determine if the gateway test is satisfied.

Gateway Relief for Plans with Broadly Available Allocation Rates

The regulations do not require a plan to pass the gateway contribution test as long as each allocation rate can meet a broadly available allocation test.[40] The broadly available test essentially treats each allocation rate in a manner similar to the way benefits, rights or features

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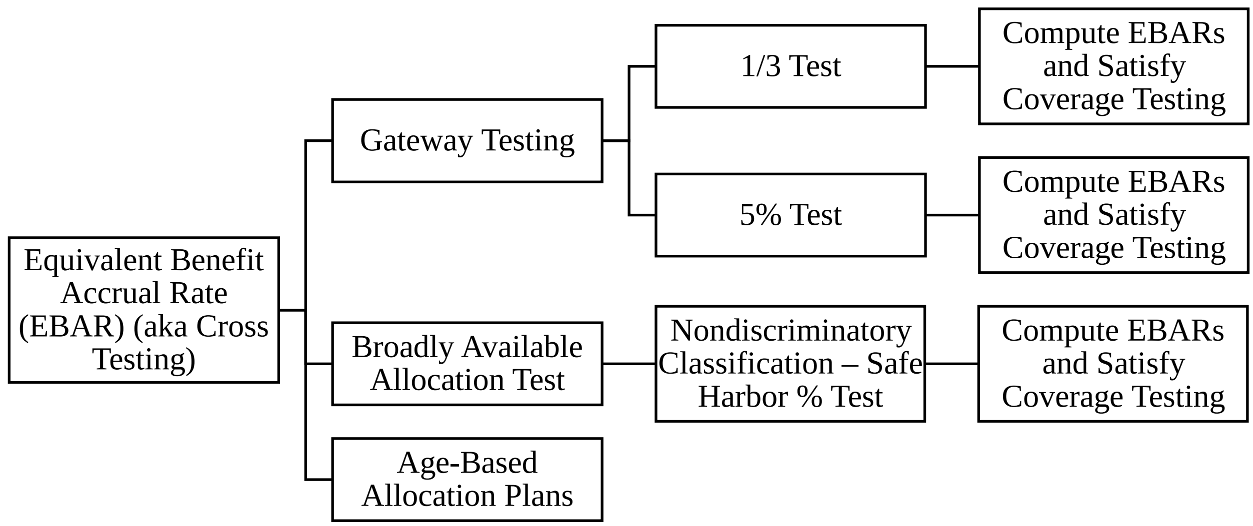
[39] Treas. Reg. §1.410(b)-7(c).
[40] Treas. Reg. §1.401(a)(4)-8(b)(iii).

(BRFs) are treated under Treas. Reg. §1.401(a)(4)-4 (which will be discussed later in this chapter). Treas. Reg. §1.401(a)(4)-4 requires that each BRF under the plan is available to a group of employees who, if they were treated as participating in a separate plan, could satisfy the nondiscriminatory classification test under Treas. Reg. §1.410(b)-4. The nondiscriminatory classification test is the first part of the average benefit test under the minimum coverage requirements. The coverage ratio percentage needed to pass the nondiscriminatory classification depends on the percentage of employees that are NHCEs (i.e., the concentration percentage) and must be within a range of 20 percent to 50 percent.



EXAMPLE 6-15. Broadly Available Allocation Rates. A profit-sharing plan provides for separate discretionary contributions for each division covered by the plan. For the plan year, Division A's allocation rate is 18 percent, Division B's allocation rate is 7 percent, and Division C's allocation rate is 2 percent. (The plan is not top-heavy, so the 3 percent minimum contribution requirement under IRC §416(c)(2) is not applicable.) There is at least one NHCE in Division C, so the plan does not satisfy the gateway contribution test (i.e., the 2 percent allocation rate does not meet the 5 percent gateway, and the contribution spread between the low of 2 percent and the high of 18 percent does not qualify under the one-third test).

Because the plan does not satisfy the gateway contribution test, the plan may not be tested on a benefits basis for the plan year unless the broadly available exception is satisfied. The NHCE concentration percentage for this employer is 80 percent. Under the table prescribed by the Treasury in Treas. Reg. §1.410(b)-4(c) (reproduced in Appendix A to Chapter 5), the safe harbor percentage needed to satisfy the nondiscriminatory classification test is 35 percent for an employer whose NHCE concentration percentage is 80 percent. To determine if the 18 percent allocation rate meets the test, the percentage of nonexcludable NHCEs who receive that allocation rate is divided by the percentage of nonexcludable

HCEs who receive that allocation rate. If the result is 35 percent or more, the broadly available allocation rate test is satisfied.

A similar test is run for the 7 percent allocation rate and for the 2 percent allocation. Note, in running the nondiscriminatory classification test for these lower allocation rates, employees who receive a rate equal to or greater than each respective rate are treated as having the lower rate available. For example, employees in Division A are treated as also receiving the 7 percent allocation rate and the 2 percent allocation rate.

If the broadly available test is satisfied, the plan may be cross-tested under IRC §401(a)(4), even though the NHCEs in Division C do not satisfy the gateway contribution test.

For purposes of calculating allocation rates that are available under the plan, differences in allocation rates attributable solely to the use of permitted disparity described in Treas. Reg. §1.401(l)-2(c) are disregarded.[41] Thus, if an allocation rate for a particular group is determined under a permitted disparity formula, all of the employees in that group are treated as having an allocation rate that equals the base contribution percentage plus the excess contribution percentage.

The broadly available test is usually not a very practical alternative. Mathematically, most plans that can demonstrate that the allocation rates satisfy the nondiscriminatory classification test are able to pass IRC §401(a)(4) on a contributions basis anyway, so they do not need to use cross-testing.

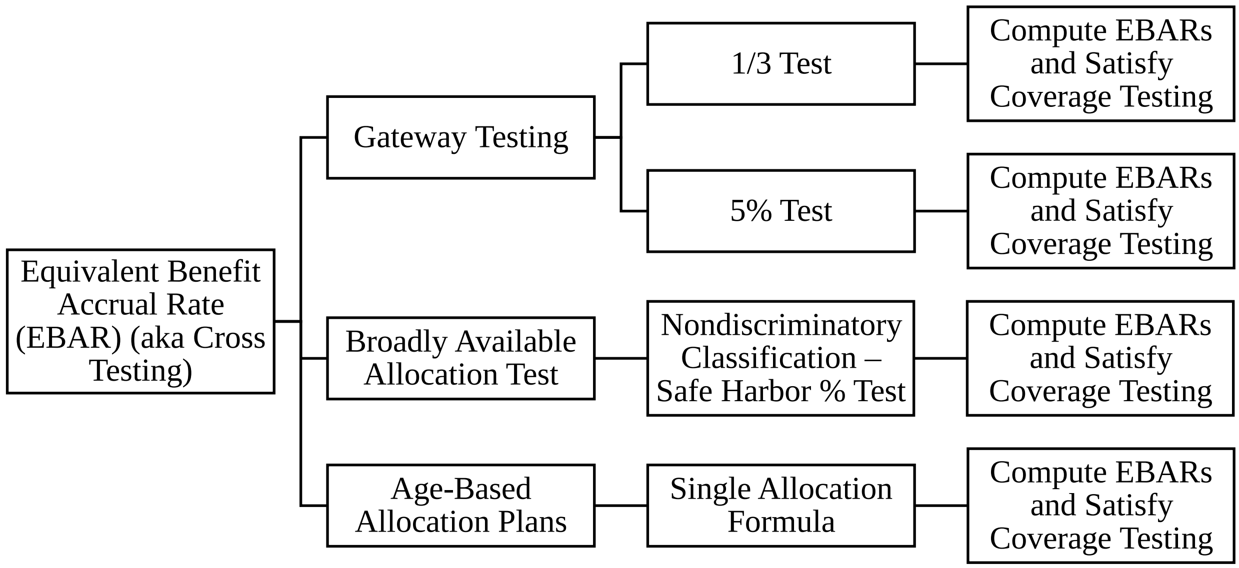
Gateway Relief for Certain Age-Based Allocation Plans

The final regulations under IRC §401(a)(4) carve out a separate exception from the gateway rules for age-based allocation plans. A plan that satisfies the age-based allocation exception is not required to satisfy the gateway contribution test nor have allocation rates that are broadly available to a nondiscriminatory group of employees. These are plans that provide either:

- A gradual age or service schedule; or
- A uniform target benefit allocation for the plan year.

To qualify under either of these definitions, the plan must use an allocation formula that applies to all employees who benefit under the plan. In other words, the plan has to use a single allocation schedule that is applicable to all participants.

[41] Treas. Reg. §1.401(a)(4)-8(b)(1)(vii).



The plans covered by this exception include most age-weighted profit-sharing plans (which allocate the employer's contribution strictly on the basis of an age-weighted allocation factor), most target benefit plans, and many points allocation plans that might need to use cross-testing to pass IRC §401(a)(4). When plans are designed in accordance with this exception, all employees, including the NHCEs, have the potential to grow into the higher allocation rates as they get older or accumulate more service with the employer, so the Treasury is not concerned with the fact that certain NHCEs receive allocation rates that are less than the gateway contribution.

DB/DC Combinations

In some cases, an employer maintains both a defined benefit (DB) plan and a defined contribution (DC) plan. Under regulations, if those plans are permissively aggregated to pass coverage and nondiscrimination testing (known as a DB/ DC combo), and the nondiscrimination test is run on the basis of benefits (i.e., normal accrual rates under the DB plan plus EBARs under the DC plan), the DB/DC combo must satisfy a special gateway test[42] unless the DB/DC combo is considered primarily defined benefit in nature, or unless the DC component and DB component of the aggregated DB/ DC combo are considered to be broadly available.

COVERAGE PRINCIPLES THAT DEMONSTRATE RATE GROUPS ARE NONDISCRIMINATORY

Once the rate groups are determined and the gateway requirements are met, the rate group testing can be performed. To pass IRC §401(a)(4), every rate group must satisfy the coverage requirements of IRC §410(b). Both the ratio percentage test and the average benefit test are available for this purpose. All of the rate groups do not have to pass the same coverage test. For example, a plan with four rate groups might pass the ratio percentage test with respect to three of

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[42] Treas. Reg. §1.401(a)(4)-9(b)(2)(v).

the rate groups and pass the average benefit test with respect to the other rate group. The application of this rule has caused a great deal of confusion, particularly in the application of the average benefit test to the rate groups.

Determining Whether the Rate Group Satisfies the Ratio Percentage Test

To pass the ratio percentage test, the employees included in the rate group must represent a coverage ratio of at least 70 percent. The coverage ratio is determined as if the employees in the rate group are the only ones benefiting under the plan.[43] In other words, when calculating the NHCE ratio and HCE ratio that applies to the rate group, the numerator of each ratio is the number of NHCE or HCE employees who are included in the rate group, and the denominator of each ratio is the number of all NHCE or HCE employees in the plan (other than employees who are excludable for coverage testing purposes). Excludable employees generally are employees who have not satisfied the plan's minimum age and service requirements, certain union employees, and nonbenefiting employees who terminated during the plan year with less than 501 hours of service. The denominators, therefore, will generally pick up all employees who have satisfied the plan's minimum age and service requirements, even if they are excluded from the plan by employment classification or their allocation rate or EBAR is too small to be included in the rate group being tested.

Take the following steps to apply the ratio percentage test to the rate group:

A. Calculate the number of NHCEs included in the rate group being tested.
B. Determine the total number of NHCEs (other than excludable employees for coverage testing purposes), including those not covered by the rate group.
C. Divide (a) by (b), and express the result as a percentage. This is the NHCE ratio percentage.
D. Calculate the number of HCEs included in the rate group being tested.
E. Determine the total number of HCEs (other than excludable employees for coverage testing purposes), including those not covered by the rate group.
F. Divide (d) by (e), and express the result as a percentage. This is the HCE ratio percentage.
G. Divide (c) by (f), rounding to the nearest one-hundredths percent. This is the coverage ratio.
H. If the coverage ratio is at least 70 percent, the rate group passes the ratio percentage test.

[43] Treas. Reg. §1.401(a)(4)-2(c)(3)(i).

Determining Whether the Rate Group Satisfies the Average Benefit Test

Any rate group that fails the ratio percentage test must be tested under the average benefit test. There are two parts to this test: the nondiscriminatory classification test and the average benefit percentage (ABP) test. The average benefit test is explained in detail in Chapter 5.

Nondiscriminatory Classification Test

The first part of this test is to show that the rate group passes the nondiscriminatory classification test. This is done in the same manner as the ratio percentage test illustrated above. However, to pass the nondiscriminatory classification test, the coverage ratio percentage must be at least equal to the midpoint between the applicable safe harbor percentage and unsafe harbor percentage in Treas. Reg. §1.410(b)-4 (or the plan's actual ratio percentage, if less).[44] The table in the Appendix to Chapter 5 includes the relevant midpoint percentages. The coverage ratio percentage needed to pass the test will depend on what percentage of the workforce (other than excludable employees) is made up of NHCEs (known as the NHCE concentration percentage). The required coverage ratio percentage for the rate group will never be greater than 45 percent, and may be as little as 20.75 percent, depending on the NHCE concentration percentage. If the rate group does not satisfy this step, stop here. The rate group fails the average benefit test, and allocations will need to be increased for some or all of the NHCEs, unless any special testing options are available.

Note that the reasonable classification test under Treas. Reg. §1.410(b)-4(b) does not have to be satisfied. Treas. Reg. §1.401(a)(4)-2(c)(3)(ii) provides that the nondiscriminatory classification test (including the reasonable classification test) is deemed satisfied if the ratio percentage for the group satisfies the midpoint test.

ABP Test

The second part is to show that the average benefits percentage (ABP) test for the employer's plans is at least 70 percent. This part is performed at the employer level, taking into account all plans maintained by the employer that are required to be included in the testing group of the plan that is being tested. To demonstrate whether this test is satisfied:

1. Calculate the benefit percentage of each NHCE (other than excludable employees for coverage testing purposes), regardless of whether the NHCE benefits from any rate group being tested under the plan or is even a participant in the plan. The rules described in Treas. Reg. §1.410(b)-5 must be used to determine benefit percentages.[45]
2. Calculate the sum of the benefit percentages of all NHCEs for whom benefit percentages were calculated in (1).

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[44] Treas. Reg. §1.401(a)(4)-2(c)(3)(ii).
[45] Treas. Reg. §1.401(a)(4)-2(c)(3)(iii).

3. Divide the sum of the benefit percentages in (2) by the number of NHCEs for whom benefit percentages were calculated in (1), including NHCEs whose benefit percentage is zero. Express the result as a percentage.
4. Calculate the benefit percentage of each HCE (other than excludable employees for coverage testing purposes), regardless of whether the HCE benefits from any rate group being tested under the plan or is even a participant in the plan.
5. Calculate the sum of the benefit percentages of all HCEs for whom benefit percentages were calculated in (4).
6. Divide the sum of the benefit percentages in (5) by the number of HCEs for whom benefit percentages were calculated in (4), including HCEs whose benefit percentage is zero. Express the result as a percentage.
7. Divide the percentage in (3) by the percentage in (6). The result is the plan's ABP.
8. If the ABP is at least 70 percent, and each rate group has passed the nondiscriminatory classification test, as determined above, the plan satisfies the nondiscrimination requirements using the rate group testing method.

Calculating Benefit Percentages under Average Benefit Test

The application of the average benefit test to rate group testing has created a great deal of confusion. Treas. Reg. §1.401(a)(4)-2(c)(2) provides that, when calculating the rate groups, only employer contributions and forfeitures under the plan being tested are taken into account to compute allocation rates or EBARs. Treas. Reg. §1.401(a)(4)-2(c)(3) (iii) provides that a rate group satisfies the average benefit percentage test if the plan of which it is a part satisfies Treas. Reg. §1.410(b)-5. This cross-reference into Treas. Reg. §1.410(b)-5 means that the plan must apply the average benefit test as if it is performing the regular coverage test, not just testing a particular rate group. The benefit percentages used to calculate the ABP must be calculated in the manner required by Treas. Reg. §1.410(b)-5, including the requirement to include contributions or benefits from all plans maintained by the employer that are part of the testing group of the plan being tested.[46] If there are other plans, the allocation rates or EBARs must be redetermined to calculate the ABP, because the contributions or benefits under the other plans must be taken into account.

Plan Includes 401(k) and/or 401(m) Arrangement

If the plan being rate group tested includes contributions made by the employer under a 401(k) plan (i.e., elective deferrals authorized under a 401(k) arrangement included in the plan) and/or a 401(m) plan (i.e., matching contributions), the allocation rates or EBARs for purposes of identifying the rate groups, are determined only on the basis of the nonelective employer contributions and forfeitures allocated as nonelective contributions. In other words, the elective deferrals and matching contributions would not be included. However, if the average benefit test is used to test those rate groups under IRC §401(a)(4), elective deferrals and matching

[46] Treas. Reg. §1.410(b)-5(d)(3).

contributions must be included when calculating the ABP. The following examples illustrate these rules and the administrative complexity created by them.

EXAMPLE 6-16. Allocation Rates Used to Perform Rate Group Test. Corporation X maintains a profit-sharing plan with a 401(k) arrangement. Corporation X does not maintain any other qualified plan. Corporation X matches 50 percent of the elective deferrals. The profit-sharing contribution is allocated under an allocation formula that does not satisfy any of the safe harbor rules. Rate group testing is used by testing allocation rates. C is a participant in the plan. The following information applies to C:

IRC §414(s) compensation = $50,000
deferrals = $2,000
matching contributions = $1,000
profit-sharing contributions = $4,000

C's allocation rate for IRC §401(a)(4) purposes is $4,000/$50,000, or 8 percent. C's 8 percent allocation rate is used to determine what rate group C is in. The allocation rates are determined solely on the basis of the profit-sharing contribution to determine whether the rate groups pass the ratio percentage test or the nondiscriminatory classification test part of the average benefit test. However, if the ratio percentage for any rate group is less than 70 percent, the average benefit test is needed. For the ABP portion of this test, C's allocation rate must be adjusted to include the elective deferrals and the matching contributions. C's adjusted allocation rate for purposes of calculating the ABP would be $7,000/$50,000, or 14 percent.

EXAMPLE 6-17. EBARs Used to Perform Rate Group Test. Assume in the above example that the nonelective contributions are being rate group tested on the basis of benefits. When computing C's EBAR, only C's profit-sharing contribution is converted into a benefit. Suppose the factor used to convert C's allocation into a benefit is 517.05. C's EBAR is $4,000/517.05, or 7.74 percent. C's 7.74 percent EBAR is used to determine what rate group C is in. The EBARs are determined solely on the basis of the profit-sharing contribution to determine whether the rate groups pass the ratio percentage test or the nondiscriminatory classification test part of the average benefit test. However, to calculate the ABP, C's EBAR must be adjusted to include the elective deferrals and the matching contributions. C's adjusted EBAR for purposes of calculating the ABP would be $7,000/517.05, or 13.54 percent.

Special Issues Relating to Qualified Nonelective Contributions (QNECs)

Assume in the prior example that Corporation X makes QNECs, which are used in applying the ADP test under IRC §401(k)(3) to the elective deferrals made for that year. C's allocation of

QNECs is $500. The QNECs are included in the ABP described in the prior example. Also note that, for purposes of calculating the rate groups for the nondiscriminatory classification test, the test must be satisfied both when the profit-sharing contributions are tested alone, and also when the QNECs are added with the profit-sharing contributions.[47] The same principles would apply if QNECs are used in the ACP test under IRC §401(m)(2).

Safe Harbor 401(k) Plans

401(k) plans and 401(m) plans are included in the ABP testing, even if the 401(k) plan satisfies the ADP safe harbor under IRC §401(k)(12) or IRC §401(k)(13), and even if the 401(m) plan consists solely of matching contributions that satisfy the ACP safe harbor under IRC §401(m)(11). In this instance, the safe harbor 401(k) plans and 401(m) plans are not included in determining the allocation rates or EBARs for purposes of identifying the rate groups. The rate groups are determined only on the basis of the nonelective employer contributions and forfeitures allocated. However, safe harbor 401(k) plans and 401(m) plans are used for purposes of calculating the ABP if any of the rate groups are unable to pass the ratio test.

Catch-up Contributions

Pre-tax elective deferrals and designated Roth contributions that are catch-up contributions are not taken into account in determining an employee's benefit percentage.[48] However, this rule applies only to catch-up contributions for the current plan year.[49] To the extent contributions for prior plan years are relevant to the benefit percentage calculation, catch-up contributions in such years are included. Thus, where the accrued-to-date method is being used to run the average benefit test, catch-up contributions from prior plan years included in the applicable measurement period are not disregarded. As discussed above, this inclusion applies only for purposes of calculating the ABP if any of the rate groups fail to pass the ratio test.

Designated Roth contributions are treated under the nondiscrimination tests in the same manner as pre-tax elective contributions.[50] Thus, except to the extent designated Roth contributions are catch-up contributions, these contributions are taken into account in computing an employee's benefit percentage.

Employer Maintains Other Plans

If the employer maintains other plans besides the one being rate group tested, those other plans (including 401(k)/401(m) arrangements in such other plans) are included when computing the ABP if the average benefit test is used to satisfy IRC §401(a)(4); that is, if any rate groups fail to pass the ratio test.

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[47] Treas. Reg. §1.401(k)-2(a)(6)(ii).
[48] IRC §414(v)(3)(B).
[49] Treas. Reg. §1.414(v)-1(d)(3)(ii).
[50] IRC §402A(a)(1) and Treas. Reg. §1.401(k)-1(f)(3).

EXAMPLE 6-18. Multiple Plans. Corporation X maintains a money purchase pension plan and a profit-sharing plan. The money purchase pension plan satisfies a design-based safe harbor for IRC §401(a)(4) purposes. The profit-sharing plan relies on rate group testing to pass IRC §401(a)(4). To identify the rate groups under the profit-sharing plan, only the employer contributions and forfeitures under the profit-sharing plan are taken into account. However, to compute the ABP, the benefit percentages must be determined by taking into account the contributions and forfeitures allocated under the money purchase pension plan as well. If the percentages are expressed as allocation rates, each employee's combined allocation of employer contributions and forfeitures under both plans is divided by his or her IRC §414(s) compensation to determine his or her benefit percentage. If the percentages are expressed as EBARs, each employee's combined allocation under both plans is divided by the appropriate factor to determine his or her EBAR. Any employee who is included in the ABP, but does not benefit from at least one of the plans, has an allocation rate or EBAR of zero percent.

If any plan included in the ABP is a defined benefit plan, the benefit percentages of the employees must be calculated either by using contributions or benefits under all the plans in the testing group. If contributions are used, the benefit percentage of an employee will be the sum of his or her allocation rate under the defined contribution plan(s) and his or her equivalent allocation rate under the defined benefit plan(s). If benefits are used, the benefit percentage of an employee will be the sum of his or her EBAR under the defined contribution plan(s) and his or her accrual rate under the defined benefit plan(s).

ABP Calculation Can Be Determined Under Different Methodology

There is no requirement in the regulations that the benefit percentages used to calculate the ABP have to be determined under the same methodology used to calculate the allocation rates or EBARs for the rate groups under the nondiscriminatory classification test. The rate groups under the nondiscriminatory classification test might be based on allocation rates or EBARs that use a different definition of compensation than what is used to compute benefit percentages under the ABP calculation. In addition, the rate groups might be expressed as allocation rates to determine whether the nondiscriminatory classification test is passed, but the ABP might be based on EBARs.

EXAMPLE 6-19. Ratio Percentage Test. Assume the following rates are calculated for a profit-sharing plan. (These rates can represent allocation rates or EBARs; the mechanics of the test are the same.)

HCE-1: 8%	NHCE-1: 9%
HCE-2: 6%	NHCE-2: 8%
HCE-3: 4%	NHCE-3: 7%
	NHCE-4: 6%
	NHCE-5: 5%
	NHCE-6: 4%
	NHCE-7: 3%
	NHCE-8: 3%

Number of employees receiving each allocation rate

	9%	**8%**	**7%**	**6%**	**5%**	**4%**	**3%**	**Total**
HCEs		1		1		1		3
NHCEs	1	1	1	1	1	1	2	8

The rate groups to test are the rates in bold in the above table (i.e., 8 percent, 6 percent, 4 percent), because those are the rates that cover at least one HCE. The employees treated as benefiting from each rate group are the ones with a rate equal to or greater than the rate being tested (i.e., all employees in the rate group column plus employees in all columns to the left of that column).

Assume the listed employees represent all employees, other than excludable employees, for coverage testing purposes.

o The 8 percent rate group covers HCE-1, NHCE-1, and NHCE-2, because these are the employees with a rate equal to or greater than 8 percent. The NHCE percentage for this rate group is 2/8, or 25.00 percent. The HCE percentage is 1/3, or 33.33 percent. The coverage percentage for the rate group is 25%/33.33%, or 75.00 percent. The rate group passes the ratio percentage test.

o The 6 percent rate group covers HCE-1, HCE-2, NHCE-1, NHCE-2, NHCE-3, and NHCE-4, because these are the employees with a rate equal to or greater than 6 percent. The NHCE percentage for this rate group is 4/8, or 50 percent. The HCE percentage is 2/3, or 66.67 percent. The coverage percentage for the rate group is 50%/66.67%, or 75.00 percent. The rate group passes the ratio percentage test.

o The <u>4 percent rate group</u> covers HCE-1, HCE-2, HCE-3, NHCE-1, NHCE-2, NHCE-3, NHCE-4, NHCE-5, and NHCE-6, because these are the employees with a rate equal to or greater than 4 percent. The NHCE percentage for this rate group is 6/8, or 75.00 percent. The HCE percentage is 3/3, or 100 percent. The coverage percentage for the rate group is 75%/100%, or 75 percent. The rate group passes the ratio percentage test.

The plan passes IRC §401(a)(4) because all rate groups satisfy the ratio percentage test. It is not necessary to perform the average benefit test. However, if at least one of the above rate groups failed to satisfy the ratio percentage test, the average benefit test would have to be satisfied.

EXAMPLE 6-20. AVERAGE BENEFIT TEST. Assume the following rates are calculated for a profit-sharing plan. The employer sponsors no other plan.

HCE-1: 8%	NHCE-1: 8%
HCE-2: 6%	NHCE-2: 7%
HCE-3: 4%	NHCE-3: 5%
	NHCE-4: 5%
	NHCE-5: 3%
	NHCE-6: 3%
	NHCE-7: 3%
	NHCE-8: 3%

Number of employees receiving each allocation rate

	8%	7%	**6%**	5%	**4%**	3%	**Total**
HCEs	1		1		1		3
NHCEs	1	1		2		4	8

Like the prior example, the rates requiring testing (in bold in the above table) are 8 percent, 6 percent, and 4 percent, because at least one HCE has each of those rates. But now the ratio percentage test is not passed for all of the rate groups.

o The <u>8 percent rate group</u> covers HCE-1 and NHCE-1, because these are the employees with a rate equal to or greater than 8 percent. The NHCE percentage for this rate group is 1/8, or 12.50 percent. The HCE percentage is 1/3, or 33.33

percent. The coverage percentage for the rate group is 12.50%/33.33%, or 37.50 percent. Because this coverage percentage fails the ratio percentage test, the average benefit test must be satisfied. The first step is to determine if the coverage percentage satisfies the nondiscriminatory classification test. The NHCE concentration percentage is 72 percent, determined by dividing the number of NHCEs (8) by the total number of employees (11). The safe harbor percentage for this concentration percentage is 41 percent and the unsafe harbor percentage is 31 percent. The midpoint between the safe harbor percentage and the unsafe harbor percentage is 36 percent. The ratio here is 37.5 percent, so the rate group passes the nondiscriminatory classification test.

o The <u>6 percent rate group</u> covers HCE-1, HCE-2, NHCE-1, and NHCE-2, because these are the employees with a rate equal to or greater than 6 percent. The NHCE percentage for this rate group is 2/8, or 25.00 percent. The HCE percentage is 2/3, or 66.67 percent. The coverage percentage for the rate group is 25.00%/66.67%, or 37.50 percent. The rate group passes the nondiscriminatory classification test because the coverage percentage is at least 36 percent.

o The <u>4 percent rate group</u> covers HCE-1, HCE-2, HCE-3, NHCE-1, NHCE-2, NHCE-3 and NHCE-4, because these are the employees with a rate equal to or greater than 4 percent. The NHCE percentage for this rate group is 4/8, or 50 percent. The HCE ratio is 3/3, or 100 percent. The coverage percentage for the rate group is 50%/100%, or 50 percent. The rate group passes the nondiscriminatory classification test because the coverage percentage is at least 36 percent.

Because all three rate groups pass the nondiscriminatory classification test, rather than the ratio percentage test, IRC §401(a)(4) is satisfied only if the ABP is at least 70 percent. The ABP for the NHCE group is determined by averaging the above rates of the NHCEs. The NHCE ABP is 4.625 percent.

The HCE average benefit percentage is 6 percent. The ABP is 4.625%/6%, or 77.08 percent. The plan passes the average benefit test and the rate groups are considered to be nondiscriminatory.

Suppose in **EXAMPLE 6-19** above that there are two NHCEs, in addition to the eight listed who are not excludable employees for coverage testing purposes, but do not benefit under the profit-sharing plan (e.g., they fail to receive an allocation of employer contributions because they terminated employment during the plan year, but they had more than 500 hours of service for the year so cannot be treated as excludable employees). Those two employees must be added to the denominator of the NHCE percentage. The coverage percentages for the rate groups would no longer pass the ratio percentage test, and the average benefit test shown in **Example 6-20** above would apply. The nondiscriminatory classification test would have to pass by including the two employees in the denominator of the NHCE ratio, and by including those employees in the NHCE concentration percentage. Also, those two NHCEs would have a benefit percentage of zero for purposes of calculating the average benefit percentage.

EXAMPLE 6-21. Effect of a 401(k) Arrangement. Suppose in **Example 6-19** and **Example 6-20** that the profit-sharing plan includes a 401(k) arrangement. If the rate groups pass the ratio percentage test, the elective deferrals (and matching contributions, if applicable) would not be considered in satisfying rate group testing under IRC §401(a)(4). If the rate groups rely on the nondiscriminatory classification test, the elective deferrals (and matching contributions, if applicable) would have to be taken into account in computing the ABP (but not in computing rate groups for purposes of the nondiscriminatory classification test).

SPECIAL RULES AND TESTING OPTIONS

There are certain testing options available under the rate group test.

Imputing Permitted Disparity

The allocation rates or EBARs can be adjusted by imputing permitted disparity.[51] This means that the allocation rates or EBARs are increased to take into account the effect of contributions made by the employer for Social Security retirement benefits (i.e., FICA taxes). Because the Social Security benefits provided to employees earning in excess of the Social Security taxable wage base are less as a percentage of compensation than those provided to lesser-compensated employees, the permitted disparity adjustment is lower for the HCEs. The result is to increase the NHCE rates to a greater extent, making the rate group test and ABP test easier to pass.

If allocation rates are being tested, the imputing rules for defined contribution plans are used. If EBARs are being tested, the imputing rules for defined benefit plans are used. Imputing permitted disparity usually helps the testing results, because the allocation rates or EBARs of the NHCEs are usually increased by a greater percentage than the rates of the HCEs.

ESOPs may not impute permitted disparity.[52]

Treating a Range of Rates as a Single Rate

Individual allocation rates or EBARs can be grouped together and treated as a single rate for testing purposes, if the rate is within a specified range above and below a midpoint determined by the employer.

For allocation rates, the range can be within 5 percent of the value of the midpoint (not five percentage points).[53]

[51] Treas. Reg. §1.401(a)(4)-2(c)(2)(iv).
[52] Treas. Reg. §1.401(a)(4)-7(d)(1) and §1.401(l)-1(a)(3) and (4).
[53] Treas. Reg. §1.401(a)(4)-2(c)(2)(v).

Restructuring

Restructuring means the division of the participants into separate employee groups, and testing each group separately under IRC §401(a)(4). (This concept is discussed more thoroughly later in this chapter.) In many cases, restructuring will not simplify the testing process unless, through restructuring, the plan can satisfy the safe harbor rules. The restructuring rules may not be used to satisfy the gateway requirement for cross-testing a defined contribution plan.[54]

Taking Credit for Nonelective Contributions Under Safe Harbor 401(k) Plan

If a 401(k) plan is designed as a safe harbor 401(k) plan, and the employer provides a safe harbor nonelective contribution to meet the ADP safe harbor, that safe harbor nonelective contribution is taken into account in calculating the rate groups under a rate group test performed on other nonelective contributions made by the employer. However, all or a portion of the safe harbor nonelective contributions are disaggregated as a separate plan for testing purposes.[55]

EXAMPLE 6-22. Use of Safe Harbor Nonelective Contribution in General Test. A profit-sharing plan includes a safe harbor 401(k) arrangement. To satisfy the ADP safe harbor, the plan provides for a 3 percent nonelective contribution for all eligible NHCEs. The nonelective contribution satisfies the safe harbor requirements under IRC §401(k)(12). The plan also authorizes the employer to make a separate, discretionary profit-sharing contribution to eligible HCEs and eligible NHCEs. The employer makes a discretionary contribution for the eligible HCEs that equals 17 percent of compensation, and a discretionary contribution for the eligible NHCEs that equals 2.5 percent of compensation. The discretionary contribution for the eligible NHCEs is in addition to the 3 percent safe harbor nonelective contribution.

To determine if the discretionary contribution satisfies IRC §401(a)(4), using the rate group testing method, the 3 percent nonelective contribution that is made pursuant to the safe harbor 401(k) arrangement, is permitted to be taken into account to calculate the rate groups. (Note that in this example, the cross-testing approach would have to be used for rate group testing purposes because the allocation rate of the NHCEs is only 5.5 percent of compensation, whereas the allocation of the HCEs is 17 percent.)

As mentioned earlier, it is also permissible to count the safe harbor nonelective contribution toward satisfying the gateway contribution. The safe harbor nonelective contribution also exempts the safe harbor plan from the top-heavy rules. Therefore, many practitioners say that this contribution does triple-duty:

[54] See Treas. Reg. §1.401(a)(4)-9(c)(3)(ii).
[55] IRS Notice 98-52, IRB 1998-46.

a. It is used to meet the nondiscrimination testing for the 401(k) portion of the plan,
b. It is used to meet the top-heavy obligations, and,
c. It may be used for both the gateway and cross-testing portions of the general test.

Remember, any NHCE qualifying for the nonelective contribution must be taken into account in determining whether the gateway requirement is satisfied.

6.05: Aggregation, Disaggregation and Restructuring

The IRC §401(a)(4) regulations coordinate closely with the coverage rules, because coverage testing is simply a requirement to cover a nondiscriminatory group of employees in the plan. Therefore, the plan for coverage testing is the same as the plan for IRC §401(a)(4) testing.[56] This means that, if the plan passes coverage without being aggregated with another plan maintained by the employer, the contributions or benefits under that plan are tested for nondiscrimination separately from any other plan the employer maintains. This separate testing does not mean contributions or benefits in other plans are necessarily ignored for all aspects of testing. As previously discussed, rate group testing may require inclusion of contributions or benefits in other plans if the average benefit test is used to support IRC §401(a)(4) compliance.

The coverage regulations provide various testing methods for showing coverage compliance, such as the annual testing method and the quarterly testing method.[57] Whatever method is used to test coverage must also be used to test nondiscrimination under IRC §401(a)(4).[58]

AGGREGATION OF PLANS

Treas. Reg. §1.410(b)-7(d) allows for the aggregation of two or more plans to pass coverage. This is known as **permissive aggregation**, because it is done at the election of the employer. If two or more plans are permissively aggregated for coverage testing, they must also be aggregated for nondiscrimination testing.[59] Plans may be permissively aggregated only if they are maintained by the same employer (or members of the same related group of employers under IRC §§414(b), (c) or (m)), and only if the plans have the same plan year.[60]

DISAGGREGATION OF PLANS

Mandatory disaggregation of plans generally refers to the required division of a plan into sections for testing purposes. Each disaggregated portion of a plan is treated as a separate plan

[56] Treas. Reg. §1.401(a)(4)-1(c)(4).
[57] Treas. Reg. §1.410(b)-8.
[58] Treas. Reg. §1.401(a)(4)-1(c)(4), last sentence.
[59] Treas. Reg. §1.401(a)(4)-9(a).
[60] Treas. Reg. §1.410(b)-7(d).

for testing purposes. Disaggregation was discussed in significant detail in Chapter 5, when examining the coverage rules.

If general testing is being used to satisfy the nondiscrimination requirements of IRC §401(a)(4), each disaggregated portion of the plan is tested as a separate plan. Therefore, rate groups are determined by excluding benefits or contributions for employees in other disaggregated portions of the plan. In applying the coverage tests to a rate group, the ratio percentage test or the nondiscriminatory classification test (whichever is applied) generally would treat employees in disaggregated groups as excludable employees. The average benefit percentage (if applicable) would be calculated by disregarding contributions or benefits in disaggregated portions of the plan, except as required by the average benefit testing rules.

If the employer has elected, for coverage testing purposes, to disaggregate the portion of a plan that covers otherwise excludable employees, the ratio percentage of coverage for each rate group that covers the statutory employees is determined by treating the otherwise excludable employees as excludable employees. Similarly, the average benefit percentage of the statutory employees would not include the benefit percentages of the otherwise excludable employees. A separate nondiscrimination test would have to be performed with respect to the contributions allocated to the otherwise excludable employees, unless all of the otherwise excludable employees who are benefiting under the plan are NHCEs. If general testing is applied to contributions or benefits for the otherwise excludable employees, the statutory employees are treated as excludable employees in calculating the ratio percentages for the rate groups and the average benefit percentage.

RESTRUCTURING

Restructuring is known as the permissive disaggregation of certain portions of a plan into component plans. A *component plan* consists of all the allocations, accruals, and other benefits, rights, and features provided to a selected group of employees.[61] The groups can be identified in any manner the employer chooses, and the composition of the groups may change from year to year, provided that each component plan could satisfy coverage under IRC §410(b) if the component plan were a separate plan. Every employee of the employer (including controlled group and affiliated service group members) can only be included in one component plan. The component plan is treated as a separate plan in applying any of the nondiscrimination tests we have discussed, including the benefits, rights and features rules discussed in the next section.

No Special Language Needed

No special plan language is needed to restructure the plan into component plans for testing purposes. However, if the employer wants to provide different benefits, rights and features to certain groups of participants, or wants to provide a different contribution, allocation or benefit formula for identified employee groups, such differences must be written into the plan.

[61] Treas. Reg. §1.401(a)(4)-9(c)(2).

Special Rules for Restructured Plans

The nondesign-based safe harbor for uniform points plans is not an available testing method for a component plan. Only general testing may be used for this type of plan.[62]

If one of the component plans is using cross-testing to demonstrate nondiscrimination, the gateway rules must be met in all component plans, including those that are not using cross-testing.[63]

EXAMPLE 6-23. Restructuring. A profit-sharing plan provides two separate allocation formulas. Formula #1, which covers all salaried employees, is a permitted disparity formula, which for the current plan year provides a contribution to each eligible participant equal to 6 percent of compensation, plus 5.7 percent of excess compensation. Formula #2, which covers all hourly paid employees, is a nonintegrated formula providing a contribution to each eligible participant equal to a uniform percentage of plan year compensation, which is 4 percent of compensation for the current plan year.

If the plan were tested as a single plan, general testing would have to be used because the allocation formula is not uniform for all employees (and, therefore, no safe harbor nondiscrimination rule applies). The permitted disparity feature in the formula for the salaried employees could result in numerous rate groups, depending on the number and compensation levels of the HCEs. Restructuring the plan into two component plans — one for salaried employees and one for hourly employees — would simplify testing because each component plan could satisfy the design-based safe harbor. To qualify for this restructuring, each component plan must satisfy coverage, applying IRC §410(b) as if each restructured component were a separate plan.

6.06: Availability of Benefits, Rights and Features

This chapter has been discussing nondiscrimination in relation to the contributions and benefits in a plan. In addition to contributions or benefits having to be nondiscriminatory, the **benefits, rights, and features** (BRFs) provided by the plan must be available on a nondiscriminatory basis.[64] There are two availability tests that must be satisfied — a **current availability test** and an **effective availability test** (both are discussed in more detail below).

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[62] Treas. Reg. §1.401(a)(4)-9(c)(3)(ii).
[63] *Id.*
[64] Treas. Reg. §1.401(a)(4)-4.

BENEFITS, RIGHTS AND FEATURES DEFINED

Definition of Benefits

Benefits, for purposes of the availability tests, are optional forms of benefit and ancillary benefits provided by the plan. The term does not encompass the allocation or benefit formulas under which the participants accrue benefits under the plan. A plan may contain two allocation or benefit formulas, each of which is available to a different group of employees. Those allocation or benefit formulas do not have to be available on a nondiscriminatory basis, but the allocations or accruals must satisfy the nondiscrimination tests described in the prior sections of this chapter.

Optional Form of Benefits

An **optional form of benefit** is any distribution alternative provided by the plan with respect to the payment of benefits.[65] Different optional forms of benefit exist if a distribution alternative is not paid on substantially the same terms as another distribution alternative. This may occur because of differences in:

- The payment schedule (e.g., lump sum vs. annuity);
- The timing of distribution commencement (e.g., the right to request distribution upon separation from service vs. the right to request distribution only after attainment of early retirement age or normal retirement age);
- Medium of distribution (e.g., cash distribution vs. in-kind distribution, such as stock); or
- Eligibility requirements for a distribution option (e.g., distribution option available only to employees in a certain division).

Ancillary Benefits

Ancillary benefits are:

- Social Security supplements
- Disability benefits not in excess of the qualified disability benefit under IRC §411(a)(9)
- Ancillary life insurance and health benefits provided under the plan
- Death benefits under a defined contribution plan
- Preretirement death benefits under a defined benefit plan
- Shut-down benefits that are not protected under IRC §411(d)(6)
- Any other similar benefits[66]

Definition of Rights and Features

Rights and features are defined by example in the regulations,[67] and include:

- Participant loan provisions
- The right to direct investment

[65] Treas. Reg. §1.401(a)(4)-4(e)(1).
[66] Treas. Reg. §1.401(a)(4)-4(e)(2).
[67] Treas. Reg. §1.401(a)(4)-4(e)(3).

- The right to a particular form of investment (e.g., a class of employer securities)
- The right to purchase additional ancillary benefits (e.g., life insurance coverage)
- The right to make rollovers and transfers to and from the plan

Different rights and features exist if they are not on substantially the same terms as another right or feature. For example, if different investment options are available to two groups of employees with respect to their right to direct investment, two separate rights exist that must be tested for nondiscriminatory availability. Rights and features also include the right to make elective deferrals under a 401(k) arrangement (and each rate of deferrals), the right to make after-tax employee contributions (and each rate of after-tax employee contributions) and the right to each rate of matching contributions.

EXAMPLE 6-24. Right to Rate of Matching Contributions. A matching contribution formula provides a 100 percent rate of match to eligible employees who have at least 10 years of service with the company. A decreasing rate of matching contributions applies to employees with less than 10 years, with a minimum rate of match of 10 percent for employees with fewer than 3 years of service. Each rate of match must be tested for nondiscriminatory availability. In this case, the 10 percent match is available to all participants; the next higher rate of match (for example, 20 percent for employees with 2 years of service) is available to all participants with at least 2 years of service, and so on. Each of these groups must be available on a nondiscriminatory basis.

Universal Availability Rule for Catch-up Contributions

Under the **universal availability rule**, a plan is treated as failing to satisfy IRC §401(a)(4) unless all participants who are eligible to make pre-tax catch-up contributions have available the same election rights with respect to pre-tax catchup contributions.[68] If the plan allows designated Roth contributions, the universal availability rule would also apply to Roth catch-up contributions.

Eligibility to Make Rollovers Before Satisfying the Plan's Eligibility Requirements

Some plans permit an employee to make a rollover contribution before he or she otherwise would satisfy the plan's eligibility requirements. The IRS refers to such an employee as a limited participant because the employee's participation rights are limited to the availability of the rollover feature until the employee otherwise satisfies the plan's eligibility requirements. This provides a new employee with a receptacle for an eligible rollover distribution from his or her prior employer's plan, even though the employee is not yet a participant in the current employer's plan. There are a number of qualification issues relating to limited participants. The right to make rollover contributions before becoming a participant in the plan is a separate right or feature within the meaning of Treas. Reg. §1.401(a)(4)-4, and must be tested for nondiscriminatory availability. When testing the availability of this right or feature, only

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[68] IRC §414(v)(4).

employees who have not satisfied the plan's requirements for participation, but are eligible to make rollover contributions to the plan, are taken into account.[69] There are two safe harbor rules that can be used to determine whether this separate right or feature is available on a nondiscriminatory basis. These same safe harbor tests are available to any benefit, right or feature (e.g., participant loans) that is made available under a plan to limited participants.

Safe harbor test #1: uniform rollover rules for all employees. Under one safe harbor, the feature is deemed to be available on a nondiscriminatory basis if the right for limited participants to make rollovers is available to all those employees — and only those employees — who are excluded from participation solely on account of the employee's failure to satisfy the minimum age and service requirements. This safe harbor is still satisfied if the plan limits the availability of the rollover right to those employees who have satisfied any lesser uniform minimum age and service requirements. For example, the plan could permit employees who have not satisfied the plan's year of service requirement, but who have been employed for at least three months, to make rollover contributions.

Safe harbor test #2: special availability test satisfied. If safe harbor test #1 does not apply, the rollover right for limited participants is available on a nondiscriminatory basis if the nondiscriminatory availability requirements are satisfied under either of the following circumstances:

- The rollover feature is treated as available only to employees who are limited participants (as if the rollover feature is not available to any other employees); or
- The rollover feature is treated as available to both limited participants and all other employees to whom the feature is available under the plan.

Differences in Employer-Provided Contributions or Benefits

Differences in the rate of employer-provided contributions (other than matching contributions) or in the rate of employer-provided benefits do not constitute separate rights and features. For example, if a profit-sharing plan provides for a 6 percent contribution to eligible participants who work in Division A, but only a 3 percent contribution to eligible participants who work in Division B, the differences in contribution rates do not have to be tested under Treas. Reg. §1.401(a)(4)-4. Similarly, if a defined benefit plan had different benefit formulas or accrual methods for different groups of eligible participants, the differences in accrual rates do not have to be tested under Treas. Reg. §1.401(a)(4)-4. The differences in contribution formulas or benefit formulas are tested for nondiscrimination purposes under the general test.

Elective Transfer of Benefits Pursuant to Business Transactions and Employment Status Changes

A defined contribution plan may allow a participant to choose an elective transfer of his or her account balance into another defined contribution plan, pursuant to a business transaction (e.g.,

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[69] Rev. Rul. 96-48, 1996-2 C.B. 31.

stock or asset sale) or employment status change (e.g., change in job classification) that results in the discontinuance of allocations for the participant's benefit under the transferor plan, even if the benefits are not immediately distributable at that time.[70] This type of elective transfer, as opposed to the elective transfer of distributable benefits, is a right or feature, rather than an optional form of benefit, for purposes of testing for nondiscriminatory availability.[71]

Plan's Method of Allocating Expenses

The method of allocating plan expenses is an example of a right or feature that is subject to the nondiscriminatory availability rule.[72] In this regard, the timing of a change in the method of allocation could raise a nondiscrimination testing issue. In Rev. Rul. 2004-10, the IRS provides the example of a plan amendment adopted in anticipation of the imminent divorce of a participant who is an HCE. The amendment changed the plan to allocate the expenses of determining whether a court order constitutes a qualified domestic relations order (QDRO) to the accounts of all participants. The plan previously allocated such expenses only to the account of the participant named in the QDRO. The IRS found the amendment to be discriminatory.

Permissively Aggregated Plans

If two or more plans are permissively aggregated for nondiscrimination testing, then the nondiscriminatory availability tests are applied as if the plans constituted a single plan. If one of the plans contains a BRF that is not in the other plan(s) in the permissive aggregation group, that BRF must satisfy the current availability test in the same manner as a single plan that offers a BRF to a specified group of participants.

EXAMPLE 6-25. BRF in a Permissively Aggregated Plan. An employer maintains two profit-sharing plans, one covering hourly paid employees and the other covering salaried employees. The plans are permissively aggregated to satisfy the coverage requirements of IRC §410(b). Only the salaried employees' plan allows for participant-directed investments. The employer will have to determine if the participant-direction feature is available on a nondiscriminatory basis, as if the two plans were a single plan and that plan offered the feature only to a select group of participants (i.e., salaried employees in this case).

NONDISCRIMINATION TESTING FOR BRFS

There are two elements to the nondiscrimination testing of BRFs: *current availability* and *effective availability*. Both tests must be passed for a BRF to be nondiscriminatory.

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[70] Treas. Reg. §1.411(d)-4, Q&A-3(b).
[71] Treas. Reg. §1.411(d)-4, Q&A-3(b)(3).
[72] Treas. Reg. §§1.401(a)(4)-1(c)(8), 1.401(a)(4)-4(e)(3)(i) and Rev. Rul. 2004-10, IRB 2004-7.

Current Availability

The current availability of a BRF is tested under the nondiscriminatory classification test, that is, the first part of the average benefit test.[73] In particular, the current availability test is passed if the BRF's availability percentage (the availability percentage for the NHCEs, divided by the availability percentage of the HCEs) is greater than or equal to the employer's safe harbor percentage (determined in the same way as for the average benefit test (from the table in the regulations, reprinted in Appendix A to Chapter 5), based on the plan's concentration percentage. An availability percentage of 50 will always pass the test. If the BRF's availability percentage is between the safe harbor percentage and the unsafe harbor percentage, the employer must demonstrate through facts and circumstances that the BRF availability is not discriminatory. If the availability percentage is less than the unsafe harbor percentage, the BRF's availability is discriminatory.

The NHCE availability percentage is equal to the number of NHCEs to whom the BRF is available, divided by the total nonexcludable NHCEs. The HCE availability ratio is equal to the number of HCEs to whom the BRF is available, divided by the total nonexcludable HCEs.

A BRF is considered to be currently available to an employee if he or she has satisfied all of the conditions imposed on its availability. For example, if a plan requires a participant to have an account balance of $10,000 or more to be able to direct investments, the feature is available only to participants with accounts of $10,000 or more. It is not important that the participant actually utilizes the BRF, only that it is available if the participant decides to do so. For example, a plan may offer a certain investment option to all participants; the fact that only 30 percent of the participants actually elect to use the option does not change its 100 percent availability.

Disregarding Certain Conditions When Testing Current Availability

The following conditions may be disregarded in determining whether a BRF is currently available.

Age and service conditions. For testing the availability of an optional form of benefit or Social Security supplement, any age and service conditions are disregarded, unless those conditions must be satisfied within a specified time (e.g., a window benefit).[74] This rule does not apply to ancillary benefits (other than Social Security supplements), rights or features.

EXAMPLE 6-26. In-Service Distribution Available After Age 50. An in-service distribution option under a profit-sharing plan is available only to participants who have attained age 50. The distribution option is an optional form of benefit that must be available on a nondiscriminatory basis. The age requirement can be disregarded in determining whether it is currently available. Therefore, if the age requirement is the only condition for electing the

[73] Treas. Reg. §1.401(a)(4)-4(b)(1).
[74] Treas. Reg. §1.401(a)(4)-4(b)(2)(ii).

distribution, it is deemed to be available to all participants and availability need not be tested.

EXAMPLE 6-27. Window Benefit. A defined benefit plan is amended to provide a window early retirement benefit under which any participant who is at least 50 and has completed 15 years of service by December 31, 2018, may elect an early retirement benefit. Because the age and service conditions must be satisfied within a specified period of time (i.e., by December 31, 2018), the age and service conditions may not be disregarded to determine whether the availability of the option is nondiscriminatory. To determine whether the nondiscriminatory availability test is satisfied, this optional form of benefit is treated as currently available only to participants who will have satisfied such requirements by December 31, 2018.

EXAMPLE 6-28. Age Requirement to Direct Investments. A profit-sharing plan permits participants who have attained age 50 to direct the investment of their account balance. In testing the investment direction feature for nondiscriminatory availability, the feature is currently available only to participants who have reached age 50. An age condition on a right or feature may not be disregarded in determining current availability.

Permissive Aggregation of BRFs

The permissive aggregation rule applies to two or more plans that are permissively aggregated for coverage and nondiscrimination testing purposes. In such cases, the BRFs in either plan must be tested for availability as if the aggregated plans were a single plan. A separate permissive aggregation rule applies with respect to the testing of two or more BRFs within a single plan (or within a group of permissively aggregated plans). If a BRF is inherently equal or greater in value than another, the two BRFs may be treated as a single BRF for purposes of testing availability. However, the one of greater value must be able to separately satisfy the current and effective availability requirements.[75] For example, suppose a profit-sharing plan offers an installment optional form of benefit to all participants. However, in Division A, the installment period may not exceed 10 years, whereas in Division B, the installment period may not exceed 20 years. The option provided to the Division B employees is inherently greater in value than the option provided to Division A employees. Thus, the 10-year installment distribution option need not be tested for nondiscriminatory availability as a separate benefit. Both installment options may be treated as a single benefit, provided that the 20-year installment option separately passes the

[75] Treas. Reg. §1.401(a)(4)-4(d)(4).

nondiscriminatory availability tests, because that option is inherently more valuable than the 10-year option.

Testing Effective Availability

Effective availability is a facts-and-circumstances test.[76] There is no mathematical safe harbor percentage as under the current availability test. An effective availability issue may arise when the BRF is not communicated to the NHCEs (or a significant percentage of them), or when the conditions for availability are designed in a way that the BRF will never be available to a significant percentage of the NHCEs.

EXAMPLE 6-29. Effective Availability. A profit-sharing plan includes a participant loan provision, but the summary plan description does not include any information about the loan provision, and the employer has not otherwise disclosed the existence of that procedure to the participants in general. The only participants who are aware of the loan feature are the owners of the company. Although, under the terms of the plan, the loan feature is currently available on a nondiscriminatory basis, the feature is not effectively available to the NHCEs because none of them knows it exists.

If You're Curious …

Plan Amendments

The timing of a plan amendment, or a series of plan amendments, may not discriminate significantly in favor of HCEs. 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.

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[76] Treas. Reg. §1.401(a)(4)-4(c).

EXAMPLE 6-30. Amendment to Increase Benefits at Time Plan is Terminated. A corporation is winding down business operations and is terminating its defined benefit plan. During the plan's existence, both HCEs and NHCEs were covered by the plan. At a time when the only remaining participants are HCEs, the plan is amended to increase benefits and is then terminated. The timing of the amendment has the effect of discriminating significantly in favor of HCEs.[77]

EXAMPLE 6-31. Past Service Favors HCEs. A corporation establishes a new defined benefit plan in 2020. The plan covers two HCEs and four NHCEs. The corporation has been in existence since 2010. 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 seven years to one year. The timing of the establishment of the plan has the effect of significantly discriminating in favor of HCEs because of the grant of past service.

EXAMPLE 6-32. No NHCEs with Past Service. Suppose, in the prior example, that all four NHCEs were hired in the current year, and the corporation never had NHCEs. In this case, the grant of past service at the time the plan is established is not discriminatory. This example illustrates that a key factor in this determination is whether the timing of the establishment or amendment of the plan has the effect of preventing a significant percentage of former NHCEs (as compared to former HCEs) from benefiting from the grant of past service.

EXAMPLE 6-33. Amendment of Uniform Benefit Formula. The benefit formula under a defined benefit plan is 2 percent of average compensation times years of participation. The plan is amended to increase the formula percentage to 2.5 percent, and that increase is applied to years of participation credited before the date of the amendment. The benefit increase caused by the application of the amended formula to prior years of participation is a grant of past service that must be tested for significant discrimination in favor of HCEs, taking into account turnover during the plan's history.

Effect of Determination Letter

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[77] Treas. Reg. §1.401(a)(4)-5(a)(4), Example 1.

Effective February 1, 2012, a favorable determination letter on a plan as amended may not be relied on with respect to whether the timing of the plan amendment satisfies this nondiscrimination requirement.[78] Determination letters issued with respect to applications filed before such date does provide such reliance.

6.07: Correcting Violations of Nondiscrimination Rules

If it is discovered that the plan violated one of the nondiscrimination rules discussed in this chapter or the coverage rules of IRC §410(b), Treasury regulations offer a solution. Treas. Reg. §1.401(a)(4)-11(g)(3) permits the plan sponsor to adopt an amendment to the plan within 9-½ months after the end of the plan year to correct the violation. The amendment cannot cut back benefits or participation by the HCEs, because that would violate IRC §411(d)(6).

Therefore, the amendment must add otherwise ineligible NHCEs to the plan, or must provide selected NHCEs with additional benefits.

The amendment must be able to pass IRC §401(a)(4) nondiscrimination rules when considered without other plan benefits, but this should be no problem if it is adding participation or benefits only for NHCEs. Furthermore, the amendment must have substance.[79] This means, for example, that the benefits being added for NHCEs cannot be only for terminated employees who were not vested at termination. Therefore, the benefit being provided under the corrective amendment may need to be vested separately from the normal plan benefit for the affected NHCEs. This type of amendment is also likely available to correct a failure in providing the gateway to all affected employees.

6.08: Review of Key Concepts

- Explain nondiscrimination testing in terms of a safe harbor approach and a general testing approach.
- What is a rate group?
- How are rate groups determined?
- Describe cross-testing.
- What are the preconditions to cross-testing in a defined contribution plan?
- Calculate an EBAR.
- How is it determined whether rate groups are nondiscriminatory?
- Describe the parts of the average benefit test.
- Determine whether elective deferrals and matching contributions are included in general testing.
- Describe permissive aggregation, disaggregation and restructuring.

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[78] Announcement 2011-82

[79] Treas. Reg. §1.401(a)(4)-11(g)(4).

- Identify ancillary benefits.
- Explain the current and effective availability tests.
- Describe the gateway test.
- Describe the interaction between coverage testing and nondiscrimination testing.
- Describe corrections that can be made when a plan does not satisfy nondiscrimination requirements.

6.09: For Practice – True or False

1. If contributions, benefits or availability of BRFs are discriminatory, a corrective amendment may be adopted within 9½ months after the close of the plan year.
2. A uniform points plan is the only type of nondesign-based safe harbor defined contribution plan.
3. A rate group consists of a single HCE and each NHCE who has an equal or greater allocation rate or accrual rate.
4. If plans are aggregated to satisfy the coverage tests under IRC §410(b), they must be aggregated to satisfy the nondiscrimination tests under IRC §401(a)(4).
5. If two or more plans are permissively aggregated for nondiscrimination testing, then the nondiscriminatory classification tests must be applied as if the plans were a single plan.
6. For purposes of satisfying the gateway contribution test, each NHCE who benefits under the plan must receive an allocation of at least 5 percent of IRC §415 compensation.
7. Age-based plans automatically satisfy nondiscrimination testing since every participant has the same EBAR.
8. Cross-tested defined contribution plans may not use the safe harbor approach to satisfying nondiscrimination under IRC §401(a)(4).
9. A plan must benefit at least one NHCE to satisfy nondiscrimination requirements.
10. Rate groups must satisfy the average benefit test.

6.10: Sample Test Questions

1. All of the following statements regarding nondiscrimination testing under IRC §401(a)(4) are TRUE, EXCEPT:
2. A design-based safe harbor plan is deemed to be nondiscriminatory.
3. A plan that provides an allocation that is a uniform percentage of compensation is a design-based safe harbor plan.
4. A plan that provides an allocation that is a uniform dollar amount to each participant is a nondesign-based safe harbor plan.
5. Design-based safe harbor plans must use a definition of compensation for allocation purposes that satisfies IRC §414(s).
6. A uniform points plan is a nondesign-based safe harbor plan.
7. None of the following provisions affect a plan's ability to rely on the IRC §401(a)(4) safe harbors, EXCEPT:

   A. Multiple entry dates
   B. Imposing a last day requirement for allocation purposes

C. Imposing an hours of service requirement for allocation purposes
D. Limiting allocations to a total of $5,000
E. Lower allocations for one or more NHCEs

8. All of the following statements regarding general testing are TRUE, EXCEPT:

A. Rate groups that satisfy the coverage tests of IRC §410(b) are nondiscriminatory under IRC §401(a)(4).
B. Rate groups can be tested by converting the employer contributions into allocation rates.
C. Rate groups can be tested by converting the employer contributions into EBARs.
D. Determining whether a defined contribution plan satisfies nondiscrimination requirements on a benefits basis is a type of safe harbor and avoids general testing.
E. Elective deferrals are included when determining rate groups for the average benefits portion of the general test.

9. Based on the following information, determine the EBAR for the following employee:

Annual Compensation	$160,000
Allocation	$35,000
Actuarial Factor	.006877

A. 3.18%

B. 6.64%

C. 31.81%

D. 66.47%

E. 664.74%

10. All of the following statements regarding EBARs are TRUE, EXCEPT:

A. EBARs may be expressed as percentages of average annual compensation.
B. The testing age used to normalize the benefits must be the Social Security retirement age.
C. EBARs may be expressed as dollar amounts.
D. The allocations used in the EBAR calculation may be based on the current plan year.
E. The allocations used in the EBAR calculation may be based on the current plan year and all prior years.

11. All of the following statements regarding gateway requirements are TRUE, EXCEPT:

A. The one-third test must be determined on the basis of IRC §415 compensation.

B. The one-third test is satisfied if the lowest permissible allocation rate for any NHCE who benefits under the plan is 2%, and the highest allocation rate for any HCE who benefits under the plan is 5%.
C. The 5 percent test is satisfied if each NHCE receives an allocation of 6% of IRC §415 compensation.
D. The one-third test is satisfied if the lowest permissible allocation rate for any NHCE who benefits under the plan is 3%, and the highest allocation rate for any HCE who benefits under the plan is 9%.
E. Compensation from date of participation may be used in the one-third test and the 5 percent test.

12. All of the following statements regarding nondiscrimination testing are TRUE, EXCEPT:

A. Plans cannot be aggregated for coverage and tested separately for nondiscrimination.
B. Plans cannot be permissively aggregated unless they have the same plan year.
C. Elective deferrals can be general tested to satisfy nondiscrimination requirements.
D. A plan may permissively disaggregate otherwise excludable employees for nondiscrimination purposes.
E. Permissive disaggregation of certain portions of a plan into component parts for nondiscrimination testing is known as restructuring.

13. All of the following statements regarding BRFs are TRUE, EXCEPT:

A. Participant loans are a right or feature subject to nondiscrimination requirements.
B. Life insurance is considered an ancillary benefit.
C. A lump sum distribution is an optional form of benefit.
D. Participant-direction of investments is a right or feature subject to nondiscrimination requirements.
E. A BRF is considered nondiscriminatory if it satisfies either the current availability test or the effective availability test.

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

6.11: Solutions to True or False Questions

1. True.
2. True.
3. False. A rate group is established for each HCE. However, there may be more than one HCE in a rate group if the HCE (not being tested) has an equal or greater allocation rate or accrual rate than the HCE being tested. The rate group consists of the HCE and each participant (HCE and NHCE) who has an equal or greater allocation rate or accrual rate.
4. True.
5. True.
6. False. The lowest allocation rate for any NHCE who benefits under the plan must be at least equal to the lesser of one-third of the highest allocation rate for any HCE or 5 percent of IRC §415 compensation.
7. False. Age-based plans are designed to satisfy nondiscrimination purposes under this premise, but the plans do not automatically pass. For example, participant EBARs could vary due to IRC §415 limitations or top-heavy minimum contributions.
8. True.
9. False. An employer with only HCEs, or where the NHCEs are excludable for coverage testing, may still satisfy nondiscrimination requirements.
10. False. Rate groups can satisfy either the ratio percentage test or the average benefit test.

6.12: Solutions to Sample Test Questions

1. The answer is **C**. A plan that allocates a uniform dollar amount to each participant is a design-based safe harbor plan and is deemed to be nondiscriminatory.
2. The answer is **E**. A plan that provides for a lower allocation to one or more HCEs may still rely on the IRC §401(a)(4) safe harbors, but not one that does the same for NHCEs.
3. The answer is **D**. General testing, or rate group testing, is performed when a plan cannot satisfy the nondiscrimination requirements under the safe harbor approach. Cross-testing, which uses defined benefit principles to demonstrate nondiscrimination in a defined contribution plan (or vice versa), is a type of general testing.
4. The answer is **C**. The EBAR is $35,000 / (.006877 * $160,000) = 31.81%
5. The answer is **B**. The testing age must be a uniform normal retirement age and is usually the normal retirement age specified in the plan.
6. The answer is **A**. The one-third test is based on allocation rates. Allocation rates are determined based on plan compensation that satisfies IRC §414(s), which may or may not satisfy IRC §415.
7. The answer is **C**. The ADP test is the only method available for elective deferrals to satisfy the nondiscrimination requirements.

8. The answer is **E**. Both tests (current and effective availability) must be satisfied for BRFs to be considered nondiscriminatory.

6.13: Appendix A: Actuarial Factor Table for Cross-Testing

Years to Testing Age	Actuarial Factor		Years to Testing Age	Actuarial Factor
0	.079486		26	.009531
1	.073259		27	.008784
2	.067520		28	.008096
3	.062230		29	.007462
4	.057355		30	.006877
5	.052862		31	.006338
6	.048721		32	.005842
7	.044904		33	.005384
8	.041386		34	.004962
9	.038144		35	.004574
10	.035155		36	.004215
11	.032401		37	.003885
12	.029863		38	.003581
13	.027524		39	.003300
14	.025367		40	.003042
15	.023380		41	.002803
16	.021548		42	.002584
17	.019860		43	.002381
18	.018304		44	.002195
19	.016870		45	.002023
20	.015549		46	.001864
21	.014331		47	.001718
22	.013208		48	.001584
23	.012173		49	.001460
24	.011220		50	.001345
25	.010341			

CHAPTER 7:

EMPLOYEE STOCK OWNERSHIP PLANS

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7.01: Key Terms

- Deemed-owned shares
- Disqualified person
- Diversification under IRC §401(a)(28)
- Diversification under IRC §401(a)(35)
- Eligible individual account plan (EIAP)
- Employee stock ownership plan (ESOP)
- Employer securities
- IRC §1042 transaction
- Leveraged ESOP
- Net unrealized appreciation (NUA)
- Nonallocation year
- Prohibited allocation
- Put option
- Qualifying employer securities
- Qualified participant
- Qualified replacement property
- Repurchase liability
- S corporation ESOP
- Stock bonus plan
- Synthetic equity

7.02: Introduction

Employee stock ownership plans (ESOPs) are defined contribution plans with special features, the most basic of which is that these plans are designed to invest primarily in securities of the plan sponsor. The principle behind ESOPs is that the sharing of ownership in the company with the employees can be advantageous for these reasons:

1. It enables employees to have an ownership outlook; they care about the financial and business health of the company because they benefit when the company does well. Proponents of ESOPs strongly believe that this results in increased productivity on the part of the workers.
2. Employees are able to share in the fruits of their labors.
3. ESOPs offer a favorable means of corporate financing and a market for the purchase of securities in closely held companies that might not otherwise be available. In fact, an employer may consider using an ESOP to finance expansion on a completely tax-deductible basis.

The Internal Revenue Code (IRC) provides employers with the following additional tax incentives to put stock into an ESOP:

- Whereas dividends paid to shareholders are normally not deductible to the corporation, dividends paid to the ESOP may be deductible.
- The participant has a potential for favorable tax treatment of the distribution from the ESOP if the distribution is in the form of employer stock.
- Selling shareholders may delay the recognition of any gain on the sale of their shares to the ESOP under IRC §1042, if the sales transaction is properly structured.

Furthermore, an ESOP provides a tool for a shareholder to gradually pass ownership from himself or herself to the employees, thereby ensuring the continuation of the company into the future.

7.03: General Description of ESOPs

An ESOP may be a stock bonus plan, or a combined stock bonus plan and money purchase pension plan. The ESOP must:

- Be designed to invest primarily in employer securities.[1]
- Satisfy the put option requirements of IRC §409(h), the distribution restrictions of IRC §409(o), the allocation restrictions of IRC §409(n) (if applicable), and the voting rights requirements of IRC §409(e), all of which will be covered in this chapter.

STOCK BONUS PLAN

A **stock bonus plan**, like a profit-sharing plan, is a nonpension plan. However, in a stock bonus plan, the benefits are distributable in employer stock.[2] 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 for profit-sharing plans. The employer may 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.

Stock bonus plans are subject to some of the rules that will be discussed in this chapter in relation to ESOPs. These include the right to demand stock distributions and the put option obligation.

GENERAL ESOP RULES

An entire plan or just a portion of a plan may be designated as an ESOP.[3] 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. The ESOP (or ESOP portion of a plan) must be designed to invest primarily in employer securities.[4] The contribution and allocation formulas under an ESOP normally operate under the same rules as for profit-sharing plans. However, a permitted disparity allocation formula may not be used with an ESOP (or under an ESOP portion of a plan).[5]

EMPLOYER SECURITIES IN AN ESOP

For ESOPs, **employer securities** are generally common stock issued by a corporation or by a controlled group member of the corporation that employs the ESOP participants.[6] For this

[1] IRC §4975(e)(7).
[2] Treas. Reg. §1.401-1(b)(1)(iii).
[3] DOL Reg. §2550.407d-6(a)(4).
[4] IRC §4975(e)(7)(A).
[5] Treas. Reg. §1.401(l)-1(a)(4)(ii).
[6] IRC §409(l).

purpose, a controlled group means a *controlled group* of corporations under IRC §1563(a), but with certain modifications.[7] The modifications bring subsidiaries that are owned by at least 50 percent (rather than 80 percent) of the common parent in the controlled group.[8] This effectively expands the definition of a controlled group in determining employer securities, but does not expand the definition of a controlled group for other qualification purposes. Note that only employees of corporations that are within the controlled group can treat stock of a corporate controlled member as employer securities.

Stock that is Not Readily Tradable

If the stock is not readily tradable, it must have a combination of voting power and dividend rights equal to or in excess of the class of common stock that has the greatest voting power, and the class of common stock that has the greatest dividend rights.[9] In other words, the stock must have the highest voting rights and dividend rights of all classes of common stock issued by the corporation.

Independent Appraisal Required Under ESOP

If an ESOP holds employer securities that are not readily tradable on an established market, an independent appraiser must make all valuations of these securities with respect to activities carried on by the plan (e.g., distributions of employer securities or allocations based on the value of employer securities).[10] An annual valuation is required. An additional valuation may be necessary if the company is buying stock for the ESOP from a source that is not the ESOP itself.

REASONS TO ADOPT AN ESOP

ESOPs offer several advantages that encourage an employer to adopt one of these plans.

Employee Motivation

Many employers believe that employees perform better when they have a stake in the profitability of the company. Employees who embrace an ownership mentality care about maximizing profits, minimizing costs and having the best product on the market. Proponents of ESOPs claim that this results in a better, more efficient operation.

Sharing with Employees

Similar to employee motivation is the attitude of an ESOP organization that employees should have a more direct share in their efforts. By owning stock through an ESOP, a broad cross-section of employees benefit from the growth of the company in ways that otherwise may not be available or practical outside of the ESOP.

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[7] IRC §409(l)(4).
[8] IRC §409(l)(4)(B).
[9] IRC §409(l)(2).
[10] IRC §401(a)(28)(C).

Corporate Financing

Through an ESOP, the employer may have access to additional funds (such as those needed for expansion) on a tax-favored basis. Customarily, when a company goes to a bank for a loan, only the interest payments on the loan are deductible; principal payments are not. However, an ESOP has the ability to borrow, either from the employer or from a third party with the employer's guarantee, to purchase stock. An ESOP that does this is called a **leveraged ESOP**. In this case, the entire loan payment—in the form of an employer contribution to the plan and then a repayment of the loan by the plan—is deductible.

Market for Shares

In a closely held company, it is often difficult for an owner to find a buyer for shares that he or she wants to sell. An ESOP may provide a market for those shares, permitting the owner of the company to sell his or her interest to employees who would otherwise be unable to afford to purchase the business. In addition, the ESOP may represent a market to purchase the interests of minority shareholders when they want to divest.

Permits Increased Contributions

Many employers can contribute more to an ESOP than otherwise would be available in a normal qualified plan. First, an employer may contribute stock, and then receive a tax deduction for that contribution. This has the effect of taking stock—a noncash asset—and converting it to a cash benefit to the corporation in the form of a tax deduction. This may permit a cash-poor company to make contributions that otherwise would be unavailable.

Secondly, if a company has a leveraged ESOP, the law expands the contribution, allocation and deduction limitations to enable the repayment of the ESOP loan. Therefore, the permissible contributions under a leveraged ESOP are greater than those that would be available in another defined contribution plan.

IRC §1042 Transaction

If the sponsoring company is a C corporation, it is possible that a shareholder who sells his or her interest to the ESOP may be able to defer the gain on that sale for a significant period of time. Under this type of transaction, called an **IRC §1042 transaction**, an owner or owners of more than 30 percent of the stock who sell that stock to the plan and reinvest the proceeds in equity or debt instruments of other unrelated U.S. companies, may defer recognition of the gain until the reinvested assets (called **qualified replacement property**) are sold. This favorable tax treatment can be very valuable to a closely held business owner when he or she wants to divest.

7.04: How a Nonleveraged ESOP Works

CONTRIBUTIONS AND STOCK PURCHASES

A sponsor of an ESOP may contribute either stock or cash to the plan. This is a feature unique to ESOPs and stock bonus plans.

Stock Contributed

If stock is contributed, the shares are allocated to participants' accounts in the same manner as cash would be, usually in proportion to compensation. In a normal profit-sharing plan that does not permit participant direction of investments, the participant's account is considered to own an undivided share of the total trust fund; that is, no allocation of actual plan assets is made to the participant's account. As a result, a participant's statement will reflect only the market value of the participant's account, not the makeup of assets that comprise that account.

By contrast, in an ESOP, the participant's account is considered to be comprised of the exact shares that are allocated to the account plus an undivided interest in the nonstock assets of the plan. As a result, both a stock account and a cash (or nonstock) account will be maintained for each participant in the plan, the former showing the number of shares of employer stock held for the participant and the latter showing the value of nonstock investments in the account. These two accounts will be reported to the participant on statements issued by the plan, and the statements will provide the participant with both the number of shares of employer stock in his or her account and their current fair market value.

Cash is Contributed

The employer may contribute cash to the plan rather than stock. In that case, the ESOP trustee uses all or part of that cash to purchase stock from an available seller. The seller may be the stock market—that is, a recognized exchange—if the stock is publicly traded. If the stock is not publicly traded, the plan will purchase the stock from the plan sponsor, a parent or an affiliate of the plan sponsor, or one or more shareholders. Customarily, a purchase by the plan of an asset from any of these sources would be a prohibited transaction (PT).[11] A statutory exemption from the PT rules permits these types of purchases to occur.[12]

Employer Security Transactions

As noted above, the purchase of stock by the plan from another shareholder or from the plan sponsor normally would be a PT. The company and the other shareholder will generally be considered disqualified persons (or parties-in-interest) to the plan, and the PT rules would

[11] IRC §4975(c)(1)(A); ERISA §406(a)(1)(A).
[12] IRC §4975(d)(13); ERISA §408(e); DOL Reg. §2550.408e.

disallow purchases or sales of assets between the plan and the disqualified persons. However, the statute provides an exemption from the PT rules if the following requirements are met:

- The purchase of the securities by the plan must not be for more than adequate consideration.
- The plan may pay no commissions on the sale.
- The amount of stock owned by the plan may not exceed any legal limits on the ownership of employer securities. These limits generally do not apply to ESOPs, which are designed to invest primarily in employer securities.

Adequate Consideration

The purchase by the plan of employer securities must not be for more than the fair market value. When the stock is publicly traded, the stock market will set this value. When the stock is closely held, however, the law states that the fair market value is determined in good faith by the trustee or named fiduciary. Courts have found that part of the adequate consideration requirement is the actual determination by the fiduciary making the investment in the employer securities or real property that the amount being paid is proper. Therefore, if the fiduciary fails to prudently investigate the value of the employer securities or real property, there is a violation of Employee Retirement Income Security Act (ERISA) and the investment is deemed improper.[13]

As a result of this requirement, purchases of employer securities by the plan are generally made in conjunction with the annual valuation of the securities by an independent appraiser (updated by the appraiser to the date of actual purchase). The updated value determined by the appraiser represents the basis for the stock purchase (or, if the employer is contributing securities, for that contribution). By having an independent expert set the market value of the stock, the fiduciary can demonstrate that he or she has taken affirmative action to properly determine that value.

No Commission May be Charged on Transaction

The prohibited transaction exemption (PTE) for acquisitions of qualifying employer securities from a disqualified person is not available unless there is no commission charged with respect to the transaction.[14] A commission includes any fee, commission, or similar charge paid in connection with a transaction, but excludes a charge incurred for the purpose of enabling the plan fiduciaries to evaluate the desirability of entering into the transaction (e.g., an appraisal or investment advisory fee).[15]

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[13] *Reich v. Hall Holding Co*., 990 F.Supp. 955 (21 EBC 2429) (N.D.Ohio 1998), as modified upon reconsideration of portion of original opinion, 21 EBC 2771 (N.D. Ohio 1998), *Chao v. Hall Holding Company, Inc*., 2002 U.S. App. LEXIS 5929 (6th Cir. April 3, 2002).
[14] ERISA §408(e)(2).
[15] DOL Reg. §2550.408e(e).

If You're Curious . . .

Limitations on the Percentage of Assets Invested in Qualifying Employer Securities

ERISA §407 limits the percentage of plan assets that can be invested in qualifying employer securities without engaging in a PT.

General Limit. If a plan acquires qualifying employer securities, the aggregate fair market value of such property held by the plan may not exceed 10 percent of the fair market value of plan assets, determined immediately after the acquisition.[16]

An acquisition includes, but is not limited to, the following:

o A purchase;

o An exchange of plan assets;

o An exercise of warrants or rights;

o A conversion of a security (except to the extent permitted under ERISA §408(b)(7));

o A default of a loan, where qualifying employer securities or qualifying employer real property was security for the loan; or

o A contribution of the securities or real property to the plan.[17]

These are the same transactions covered by the PTE for purchases of employer securities by the plan.[18]

Stock acquired by the plan as a result of a stock dividend or a stock split is not an acquisition for purposes of ERISA §407.[19]

The 10 percent limit on qualifying employer securities, to the extent applicable to a plan, is violated if the limit is exceeded as a result of an acquisition of the securities or employer real property. If the acquisition of qualifying employer securities satisfies the statutory limit, but, subsequent to the sale, the market value of such assets increases to the point that it exceeds 10 percent of the market value of the plan's total assets, there is no violation of ERISA §407. However, while the market value of the qualifying employer securities held by the plan exceeds the 10 percent limit, there can be no further acquisition by the plan of qualifying employer securities.

Exception from General Limit for Eligible Individual Account Plan. ERISA §407(b)(1) exempts an **eligible individual account plan** (EIAP) from the 10 percent limitation. An EIAP must be a profit-sharing plan, stock bonus plan or ESOP.[20] A 401(k) plan may be such a plan because it is qualified as either a profit-sharing plan or stock bonus plan.

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[16] ERISA §407(a)(2
[17] DOL Reg. §2550.407a-2(b).
[18] DOL Reg. §2550.408e(b).
[19] DOL Reg. §§2550.407a-2(b) (last sentence) and 2550.408e(b) (last sentence).
[20] ERISA §407(d)(3)(A).

To be an EIAP, the plan must explicitly provide for the acquisition and holding of qualifying employer securities in excess of the 10 percent limitation.[21] An ESOP is a type of EIAP. However, ESOPs are permitted to engage in certain special transactions and are subject to additional requirements that are not applicable to regular EIAPs.

Purchase of Stock from Shareholder Who Elected IRC §1042 Transaction

As stated earlier, one of the benefits to a shareholder of a C corporation who sells shares to the ESOP is that the shareholder may be able to defer the gain on that sale for a significant period of time. The following requirements must be met:

- The seller must have owned the stock sold to the ESOP for at least three years.
- The ESOP must own at least 30 percent of the employer's stock after the sale.
- The proceeds from the sale of the securities to the ESOP must be reinvested in qualified replacement property.
- Qualified replacement property, as defined in IRC §1042(c)(3), must be purchased within a period that begins three months before the date of the sale of the employer securities to the ESOP and ends 12 months after such date.
- A statement of purchase must be prepared, notarized and then filed with the seller's tax return.[22]
- The seller, member of the seller's family and other more than 25 percent shareholders cannot receive allocated shares acquired in the transaction during the "nonallocation period."

Qualified Replacement Property Defined

Qualified replacement property means a security issued by a domestic operating company which: (1) did not have passive investment income in excess of 25 percent of gross receipts for the taxable year preceding the taxable year in which the securities are purchased, and (2) is not the corporation which issued the qualified securities that were sold to the ESOP (or a member of the same controlled group of corporations within the meaning of IRC §1563).[23] For plan years beginning on or after January 1, 2012, the Internal Revenue Service (IRS) will use the definition in Treas. Reg. §1.401(a) (35)-1(f)(5) to determine whether employer securities are readily tradable for IRC §1042 purposes.[24]

Seller's Family Defined

The following are considered the seller's family members for purposes of the IRC §1042 transaction, defined under IRC §267(b):

- Spouse

[21] ERISA §407(d)(3)(B).
[22] Treas. Reg. §1.1042-1T, Q&A-3(b).
[23] IRC §1042(c)(4) determination of whether employer securities are readily tradable.
[24] Notice 2011-19.

- Siblings (brothers, sisters)
- Lineal ancestors (grandparents, great-grandparents)
- Lineal descendants (children, grandchildren)

There is an exception to excluding lineal descendants from receiving allocated shares. The 5 percent *de minimis* rule says that if the aggregate amount allocated to all of the seller's lineal descendants does not exceed 5 percent of the employer securities acquired with the IRC §1042 transaction, then the lineal descendants would not be excluded in the allocation.[25]

25 Percent Shareholder Defined

A 25 percent shareholder is defined for purposes of the IRC §1042 transaction under the constructive ownership rules of IRC §318(a).

Nonallocation Period Defined

The nonallocation period is the period beginning on the date of the sale of the securities and ending on the later of:

- The date that is 10 years after the date of the sale, or
- The date of the plan allocation attributable to the final payment of any acquisition indebtedness incurred in connection with the sale.[26]

Penalty on Early Disposition of Securities Acquired by ESOP in a §1042 Transaction

IRC §4978 imposes an excise tax if the ESOP disposes of securities acquired in an IRC §1042 transaction within the three-year period following its acquisition of the securities, and: (1) the total number of shares held by the plan after such disposition is less than the total number of employer securities held immediately after the §1042 transaction, or (2) the value of qualified securities held by the ESOP after such disposition is less than 30 percent of the total value of all employer securities as of such disposition. The excise tax is 10 percent of the amount realized on the disposition. There are exceptions for certain dispositions, such as dispositions to satisfy distributions on account of death, retirement, disability or a separation from service that results in a one-year break in service. The IRC §4978 tax is payable by the employer, using Form 5330, and is due by the end of the 7th month following the close of the employer's taxable year in which the disposition occurs.

Allocation of Purchased Stock to Participants' Accounts

Once the stock is purchased by the plan, the shares are allocated to participants' accounts. If the contribution was used to purchase the stock, the stock allocation will be in proportion to that contribution. On the other hand, an ESOP trustee may take a portion of each participant's account that was previously invested in other assets and use those funds to purchase employer securities. In that case, the allocation of the purchased securities will be in proportion to the

[25] 1986 Technical Corrections Blue Book at 155.
[26] IRC §409(n)(3)(C).

nonstock investments in each participant's account prior to the purchase (the participant's account will be considered to have decreased its nonstock investments in the same amount as the value of the allocated stock to effectuate this purchase).

ANNUAL VALUATIONS

The employer securities held by an ESOP must be valued annually for the following four reasons:

1. IRC and ERISA regulations require that qualified plans be valued at least annually at fair market value.[27]
2. The value of any contribution made by the employer and the allocation to participants' accounts must be determined to ensure that all applicable limitations are met.
3. Participants who have left the company must know the value of their stock accounts for purposes of deciding whether to take a distribution from the plan, and for determining the tax liability for that distribution.
4. Any participants who have received a distribution and want to sell their stock back to the plan must know the value of the stock to do so.

If a stock is publicly traded, it is easy to determine the fair market value at any time; the value is the price on the exchange.[28] Greater challenges are faced when the stock is not publicly traded, as the only market for the stock in a given year may be the ESOP itself. As a result, a plan holding securities that are not publicly traded is required to retain the services of an independent appraiser each year.

The appraiser will examine the company and determine a stock value. In addition, the appraiser will issue a report to the trustee outlining the determined fair market value, the methodology and assumptions used in determining that value. The stock valuation may take into account many factors, in addition to the value of the assets owned by the company, including:

- the sales income for the year,
- the cost of goods sold during the year,
- the debt load of the company, and
- whether the ESOP's interest in the company is a majority or a minority interest.

Because the value of the stock owned by the ESOP is generally determined only once per year, the appraisal will be the basis for most, if not all, of the stock transactions that will occur in the ESOP that year. Because the appraisal is as of the last day of the plan year, if there are stock transactions which will occur between the company and the ESOP, the ESOP trustee will have the appraiser update that annual appraisal for any changes between the end of the plan year and the date that the transactions will actually take place. Then, the ESOP trustee and the plan administrator usually will transact all stock-related business at the same time, immediately

[27] ERISA §103; Rev. Rul. 80-155, 1980-1 C.B. 84.
[28] ERISA §3(18).

following that update and based on that updated value. These transactions could include stock contributions and purchases or redemptions of employer stock.

DISTRIBUTIONS

Taxation of Distributions of Stock

When a participant becomes eligible for a distribution from the ESOP, he or she is generally provided with the employer securities held in the vested account (for whole shares) plus cash equal to the nonstock investments in the vested account and any partial shares held by the vested account. However, the participant generally has the right to demand that his or her entire account be distributed in the form of employer securities. If the stock distributed to the participant consists of qualifying employer securities and the vested account is paid in one calendar year, the participant is taxed only on the value of the shares when they were purchased by the ESOP (i.e., the book value), not on the fair market value at distribution.[29] This permits the participant to defer taxation on the difference between the current value of the securities and the cost basis, which is called the **net unrealized appreciation** (NUA) of the employer securities. When the distributed securities are ultimately sold by the participant, the taxable gain will be the difference between the proceeds from the sale and the book value on which tax was paid at the time of distribution.

Calculating NUA

NUA is the difference between the value of the employer securities at the time of distribution and the plan's cost basis in the securities.[30] If the value of the securities is less than the plan's cost basis, the NUA is zero.

EXAMPLE 7-1. Determination of NUA. B is a participant in Corporation A's ESOP. In 2019, the ESOP purchased 500 shares of Corporation A stock at $100 per share. B's allocation of those shares was 10 shares. In 2020, B terminates employment and takes a distribution of those shares. The value of the shares at that date is $150 per share.

The value of the distribution to B is $1,500. However, the value at purchase was $1,000 ($100 x 10 shares). The difference between the two—$500—is the net unrealized appreciation, or NUA. If B qualifies for the special tax treatment, B will be taxed only on $1,000 of ordinary income, and the NUA will be taxed only when B sells the stock.

[29] IRC §402(e)(4).
[30] Treas. Reg. §1.402(a)-1(b)(2).

EXAMPLE 7-2. Negative NUA. Suppose in the prior example that Corporation A stock is worth $90 per share in 2020 when B takes the distribution. In that case, there is a decrease in net value (or a net unrealized depreciation) of $10 per share, or $100 total for B. In that case, the NUA is deemed to be $0.

Cost basis. A plan that holds employer securities must compute its cost basis in those securities under one of the four methods outlined in Treasury regulations.[31] An average cost method is used unless securities are earmarked for the account of a particular employee, or basis can be determined separately with respect to allocation periods or a particular security type. An IRS ruling outlines the four methods of determining cost basis in employer securities.[32]

NUA on Rollover to Another Qualified Plan

If the employer securities are rolled over to another qualified plan, the recipient plan's cost basis in the rolled over securities equals the current value of the securities, rather than the distributing plan's cost basis.[33] The IRS takes this position even if the rollover is a direct rollover under IRC §401(a)(31), because a rollover is treated as a distribution. If the transaction is a trustee-to-trustee transfer (including an elective transfer) rather than a rollover, the cost basis in the transferor plan is carried over.[34]

Exclusion of NUA in Lump-sum Distribution

If a lump sum distribution includes employer securities, the participant may elect to exclude from gross income the entire amount of the NUA.[35] The law requires that the entire balance to the credit of a participant must be paid within one taxable year to qualify for the NUA exclusion.[36] Payment of the balance may include a direct rollover of the non-securities portion of the lump sum distribution. However, the direct rollover must be paid in the same taxable year as the distribution of the employer securities, or this requirement is not satisfied.

EXAMPLE 7-3. Deferred Taxation of NUA on Lump-sum Distribution. S receives a lump sum distribution from S's employer's profit-sharing plan. The distribution consists of the following: $5,000 cash and 500 shares of employer securities. The employer securities are valued at $100 per share ($50,000 total value) and have a cost basis of $40 per share ($20,000 total basis) for NUA of $30,000.

S directly rolls over the cash to an IRA, along with 200 shares of employer securities. S receives the remaining 300 shares of employer securities.

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[31] Treas. Reg. §1.402(a)-1(b)(2)(ii).
[32] PLR 199951052.
[33] PLR 9424067.
[34] Rev. Rul. 80-138, 1980-1 C.B. 87.
[35] IRC §402(e)(4)(B).
[36] IRC §402(e)(4)(D)(1).

S has received a lump sum distribution for purposes of the NUA exclusion, even though the cash and 200 shares of employer securities were rolled over. The value of the distributed shares (300 shares) is $30,000 and the cost basis of those shares is $12,000, resulting in NUA of $18,000. S may exclude the NUA from income, so the taxable amount of S's distribution is only $12,000 (assuming the cost basis in the employer securities is attributable entirely to employer contributions).

# Shares Distributed	Cost Basis (Taxable Amount)	Market Value at Distribution	NUA at Distribution
300	300 × $40 = $12,000	300 × $100 = $30,000	$30,000 – $12,000 = $18,000

If S was to take advantage of the NUA exclusion with respect to all 500 shares, S could receive distribution of all the shares, and roll over only the cash ($5,000). In that case, the value of the distributed shares (500 shares) would be $50,000 and the cost basis of those shares would be $20,000, resulting in NUA of $30,000. S could exclude the NUA from income, so the taxable amount of S's distribution of 500 shares of employer securities would be only $20,000 (assuming the cost basis in the employer securities is attributable entirely to employer contributions).

# Shares Distributed	Cost Basis (Taxable Amount)	Market Value at Distribution	NUA at Distribution
500	500 × $40 = $20,000	500 × $100 = $50,000	$50,000 – $20,000 = $30,000

Limited Exclusion of NUA if Distribution is Not a Lump-sum Distribution

If the distribution is not a lump sum distribution (e.g., a partial lump sum or a payment in installments) only the portion (if any) of the NUA attributable to employer securities acquired with after-tax employee contributions is excluded from gross income.

Date Employer Securities Considered Distributed

The IRS has ruled that when the trustee of the plan, intending to relinquish legal title, delivers the stock certificates to the corporation's transfer agent with instructions to reissue them in the name of the distributee, the distributee becomes vested in both the legal and equitable interest in the stock as of the date the trustee made delivery to the transfer agent. Therefore, NUA is computed as of the date of such delivery to the transfer agent.[37]

Determining Taxable Portion of Distribution

The rules of IRC §72 are applicable to determine the taxable portion of the distribution when it includes employer securities, with the following modifications.

Exclusion of NUA. Any NUA that is excluded from income, as described above, is subtracted from the total distribution to determine the taxable portion.

The plan's cost basis in the employer securities is includible in gross income, except to the extent it represents a recapture of the participant's basis in the plan. The plan's cost basis is different from the participant's basis in the plan. The plan's cost basis is the cost of acquiring the employer securities for purposes of calculating NUA, whereas the participant's basis represents amounts previously taxed to the participant (e.g., after-tax employee contributions).

Partial withdrawals. If after-tax employee contributions are invested exclusively in employer securities, any distributed securities that are purchased with after-tax employee contributions will be entirely excludable from income, because the NUA portion is excludable and the plan's cost basis in the securities consists entirely of after-tax employee contributions. If some of the after-tax employee contributions are not invested in employer securities, a formula is applied that takes into account the after-tax employee contributions to determine what portion of the plan's cost basis in the distributed securities is treated as a return of after-tax employee contributions for tax purposes.[38]

No Early Distribution Tax on NUA Portion

The 10 percent tax on early distribution under IRC §72(t) is not applicable to any NUA that is excluded from income. The penalty only applies to the taxable portion of the distribution.[39]

Put Option

If the stock is publicly traded, the participant has a ready market for the distributed shares whenever he or she wants to sell them. If, however, the stock is not publicly traded on any established exchange, the participant may be stuck with securities on which he or she is currently taxed (based on book value rather than current value) for which he or she does not have a buyer. As a result, the IRC provides for a mandatory put option from the participant to the company.

A **put option** permits the holder of stock to demand that another person buy the stock at a given price. In this case, the put option permits a participant (or, in the case of a deceased participant,

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[37] Rev. Rul. 81-158, 1981-1 C.B. 205.
[38] IRS Notice 89-25, 1989-1 C.B. 662, Q&A-1.
[39] Treas. Reg. §54.4981A-1T, c-4(c).

his or her beneficiary) to present the stock to the company and demand that the company buy back the stock at the then-current fair market value.[40]

The ESOP put option permits the participant to require the company to buy the stock at any time during the following two option periods:

A. The **first put option period** must begin on the date of distribution and continue for at least 60 days. If the participant does not elect to put the stock to the company during that period, the plan must provide a second opportunity.
B. The **second put option period** must be for at least 60 days, and must begin during the following plan year but after the participant or beneficiary has been notified of the new fair market value for that year.[41]

If the shares were distributed as a part of an installment distribution rather than as a lump sum payment of the participant's entire account, the company must actually pay the participant for the put stock within 30 days after the participant exercises the put option.[42] If the shares were distributed in a total distribution (i.e., the participant's entire vested interest is paid within one calendar year), payment must also commence within 30 days after the exercise of the put option; however, the employer may pay the purchase price to the participant in substantially equal annual installments over a period not exceeding five years. If the employer pays the purchase price in installments, it must provide adequate security for any unpaid balance.[43]

If the participant does not take action to put the stock during the two mandatory put option periods, he or she may be required to wait until the plan or the company wants to repurchase the stock.

Exceptions to Required Stock Distributions

In certain circumstances, an ESOP is not required to distribute stock and may pay participants the equivalent value of their accounts in cash. In particular, if the articles of incorporation or bylaws for the company limit stock ownership to the ESOP and employees of the company, the ESOP does not need to (and, if the distributee is no longer employed by the company, cannot) distribute stock. In such situations, the ESOP converts the stock in the participant's account to cash, either within the plan itself by exchanging that stock with cash accounts of other participants or through a sale of the stock to the employer or another shareholder, and distributes only cash.[44]

A second situation in which stock distributions need not be permitted is when the plan sponsor is an S corporation. Effective in 1998, Congress permitted ESOPs to own stock in S corporations, and S corporation ESOPs have become very popular.

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[40] IRC §409(h).
[41] IRC §409(h)(4).
[42] IRC §409(h)(6).
[43] IRC §409(h)(5).
[44] IRC §409(h)(2).

The law limits the number of shareholders in an S corporation to 100. If stock sales or issuances result in a shareholder count that exceeds 100, the S corporation status is terminated and the corporation is automatically converted to a regular or C corporation. This has significant tax ramifications for the corporation. While the stock is in the ESOP, the ESOP is the shareholder and counts as only one of the permissible 100 shareholders. On the other hand, the dispersion of stock to hundreds of former plan participants could terminate the S election. As a result, IRC regulations exempt S corporation ESOPs from the requirement of distributing benefits in the form of stock, and S corporation ESOPs generally distribute cash in lieu of stock.[45]

Maximum Distribution Payment Period

A participant in an ESOP must have the right to elect a distribution within one year after the close of the plan year in which he or she separates from service by reason of attainment of normal retirement age, disability or death. For separations due to other reasons, the participant must have the right to elect a distribution within one year after the fifth plan year following his or her separation.

Notwithstanding the above requirements, the account should be distributed in substantially equal payments made at least annually over a period not to exceed five years, unless the participant elects otherwise,[46] as long as the account balance does not exceed $800,000. If the account balance exceeds $800,000, the maximum five-year period is increased by one additional year (up to five additional years) for each $160,000, or a fraction thereof, that the account balance exceeds $800,000. The $800,000 and $160,000 amounts in the preceding sentence are indexed for cost-of-living adjustments (and are equal to $1,150,000 and $230,000, respectively, for 2020).

If the ESOP is leveraged, the ESOP may be permitted to delay distributions of securities to the participants until the loan is completely repaid. This permits the plan to avoid having the lender and the participants compete for available cash reserves while the loan is outstanding.

However, while a leveraged ESOP may delay distributions until the loan is paid, a distribution cannot be delayed if either of the following two situations apply:

1. If a required minimum distribution under IRC §401(a)(9) is due, or
2. If a distribution is required to be paid under IRC §401(a)(14). IRC §401(a)(14) states that a distribution must commence no later than the 60th day after the end of the plan year in which the latest of the following occurs:

- Earlier of Age 65 or the plan's normal retirement age;
- The 10th anniversary of the date on which the participant began participating in the plan; or
- Termination of the participant's service.

[45] IRC §409(h)(2)(B)(ii).
[46] IRC §409(o)(1)(C).

Whether the participant could elect a different distribution period than the payment period described above depends on the terms of the plan. The plan may permit the participant to elect a shorter or longer period for payment.

An ESOP or stock bonus plan is permitted to eliminate, or to give the employer the discretion to eliminate, a single sum or installment optional form of distribution with respect to benefits that are subject to the put option requirement relating to employer securities that are not readily tradable on an established market.[47] This grant of discretion could be coordinated with the maximum payment requirements under IRC §409(o). In other words, through its exercise of discretion granted under the plan, the employer might eliminate an installment option that would allow a shorter distribution period (with respect to employer securities) to use the maximum distribution period under the plan to limit the flow of distributable employer securities for which a put option might be exercised.

DIVERSIFICATION

As ESOP participants near retirement, they often become concerned about having such a large portion of their retirement savings invested in employer securities. In general, stocks are considered to be a more risky venture than many other investments because they tend to be more volatile and there is a possibility of a loss of principal. This concern about maintenance of value may be heightened with stock held in a relatively small, closely held corporation if the participant perceives the company to be more volatile than a company in a national market.

To be sensitive to the participant's concerns when he or she is close to retirement, the law provides for two sets of requirements that permit participants to diversify their ESOP accounts out of employer stock. The first is the normal ESOP diversification rules, found in IRC §401(a)(28). The second requirement applies to all defined contribution plans with employee contributions or elective contributions that are invested in publicly traded employer securities and is found in IRC §401(a)(35).

Congress amended the IRC in 1986 to require plans to offer participants nearing retirement the opportunity to diversify the investment of their accounts.[48] **Diversification under IRC §401(a)(28)** applies only to stock acquired by the ESOP after December 31, 1986. Diversification may occur in one of three ways:

1. The plan may make a cash distribution to the participant equal to the elected diversification amount;
2. The plan may offer the participant three investment alternatives (other than employer stock) within the ESOP; or
3. The plan may permit the participant to transfer the amounts available for diversification to the company's 401(k) or profit-sharing plan (assuming it has one), as long as the

[47] Treas. Reg. §1.411(d)-4, Q&A-2(d).
[48] IRC §401(a)(28)(B).

401(k) or profit-sharing plan provides the participant with the ability to direct his or her investments into at least three alternatives, not including an employer stock fund.[49]

Diversification is available for a plan year to a **qualified participant**—that is, a participant who is at least age 55 and has ten years of plan participation as of the end of the plan year.[50] Neither the IRC regulations nor any other guidance provides a definition for years of participation. Presumably, an employee should be treated as having a year of participation if he or she is a participant for any portion of a plan year, and the participant therefore would satisfy the requirement for ten years of participation in the tenth plan year in which he or she is a participant in the plan. For this purpose, participant includes terminated individuals who still have an interest in the plan. Furthermore, whether the participant was entitled to an allocation for each plan year because of an hour-of-service condition or last day employment condition, could affect his or her status as having a year of participation during that year for purposes of the diversification requirement, depending on the definition of year of participation for diversification. It is recommended that the ESOP plan document be drafted in a manner which specifically defines the term years of participation for purposes of diversification.

For example, suppose an employee becomes eligible for the ESOP on January 1, 2010, and the plan year ends December 31. The employee has ten years of participation as of December 31, 2019.

A qualified participant must be permitted to diversify up to 25 percent of the portion of his or her account balance that is invested in employer stock. The diversification period continues for a total of five years at the 25 percent level. In the sixth year, the participant must be allowed to diversify up to 50 percent of his or her account balance that is invested in employer stock. The amount available for diversification each year during the election period is reduced by the amount that has already been diversified.[51]

EXAMPLE 7-4. Diversification of a Participant's ESOP Interest. D's account contains 10,000 shares of employer stock valued at $50,000 ($5 per share) for the first year in the diversification election period. D must be permitted to diversify 25 percent (2,500 shares) for that year. D diversifies the full amount available, and receives a distribution of the cash equivalent of the shares, $12,500.

During the second plan year of the diversification election period, no additional allocations of employer securities are made to D's account. The total amount available for diversification is the 7,500 shares remaining in D's account, plus the already diversified shares (2,500 shares) times 25 percent, which equals 2,500 shares. Because D has already diversified 2,500 shares, D is unable to diversify anything more for the second year.

[49] IRC §401(a)(28)(B)(ii).
[50] IRC §401(a)(28)(B)(iii).
[51] IRC §401(a)(28)(B)(i).

In the third year of the diversification election period, D's account receives a new allocation of 200 shares. The total amount available for diversification is the current number of shares (7,700 shares), plus the diversified amount (2,500 shares), times 25 percent (10,200 x .25 = 2,550 shares). Subtracting out the number of shares already diversified (2,500), 50 shares are now eligible for additional diversification.

Year	Shares in Account	25% of Shares in Account Plus Prior Diversified	Amount Previously Diversified	Allowable New Diversification
1	10,000	2,500	0	2,500
2	7,500	.25(7,500 + 2,500) = 2,500	2,500	0
3	7,700	.25(7,700 + 2,500) = 2,550	2,500	50

The diversification amount is based on the number of shares and not on the value of those shares. Even if the fair market value of the shares increased in the second year in the example above (so that the total value of the shares had increased above the value of the shares when the first year diversification took place), no further diversification rights were available for D, because D had already diversified the maximum number of shares.

The participant may elect diversification anytime during the diversification election period, which is the 90-day period beginning with the last day of the plan year in which he or she is eligible for diversification.[52] Once the election is made, the plan administrator has 90 days in which to affect the diversification.[53] In closely held companies, the share value may not be available until after the 90-day period. Generally, the participant is notified of the 90-day period in the summary plan description and allowed to make the diversification election once the share value is known. Alternatively, the plan sponsor can provide a participant the opportunity to make a preliminary diversification election within the 90-day period, and then offer a final diversification election once the share value is known.

Because diversification is a requirement under IRC §401(a), a failure to permit a participant to diversify is grounds for disqualification of the plan.

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[52] IRC §401(a)(28)(B)(iv).
[53] IRC §401(a)(28)(B)(ii).

If You're Curious . . .

Diversification under IRC §401(a)(35)

The second type of **diversification, which is pursuant to IRC §401(a)(35)**, applies to any defined contribution plan that holds publicly traded employer securities. There are different requirements for elective contributions, after-tax employee contributions, and rollover accounts than for nonelective contribution accounts.

A plan covered by these rules must allow participants to diversify out of their employer security investments in their accounts, and reinvest the proceeds of such divestiture in the other investment options available in the plan. Participants must be allowed to diversify their salary deferral contributions, employee contributions, and rollovers anytime.[54] Diversification of the nonelective contribution account must be available only to participants who have at least three years of service (or a beneficiary of such a deceased participant or an alternate payee of such participant).[55]

ESOPs are not subject to this diversification requirement if they do not provide for elective contributions, matching, or after-tax employee contributions, and the ESOP is a separate plan with respect to any other defined benefit or defined contribution plan (within the meaning of IRC §414(l)).[56]

FORFEITURE AND REALLOCATION OF UNVESTED PORTION

As with other defined contribution plans, the unvested portion of a terminated participant's ESOP account will be forfeited at some point. A plan may provide that this forfeiture will occur at the time that the participant receives a complete distribution of his or her vested account, if the plan provides for a restoration of a participant's account on rehire before he or she incurs five one-year breaks in service. Alternatively, the plan may provide that a participant must incur five one-year breaks in service before the unvested portion of his or her account is forfeited.

Forfeitures may be used to reduce employer contributions, or they may be reallocated to participants' accounts. The latter is more common, and the reallocation is normally in proportion to compensation.

When a participant forfeits part of his or her account, the forfeiture is made up of cash and stock. Forfeitures that occur during the year are held in suspense until the plan's end-of-year allocation date. These unallocated forfeitures may provide a pool of cash with which the plan may repurchase stock from terminated participants during the year, thereby avoiding a sale of stock to the company or shareholders during the year.

[54] IRC §401(a)(35)(B); Treas. Reg. §1.401(a)(35)-1(b).
[55] IRC §401(a)(35)(C); Treas. Reg. §1.401(a)(35)-1(c).
[56] IRC §401(a)(35)(E); Treas. Reg. §1.401(a)(35)-1(f)(2)(ii).

When the forfeitures are reallocated, the reallocation maintains the classification of the forfeiture as stock or cash. Therefore, the participant's cash account will be increased by the amount of nonstock forfeitures, and the participant's stock account will be increased by his or her share of the forfeited stock.

REPURCHASE LIABILITY

In a closely held corporation, when participants exercise put options or become eligible for diversification, the stock in their accounts must be sold. The buyer for that stock may be the plan, the corporation or possibly the other shareholders. If the plan is fully invested in stock, it is likely that the corporation will be required either to buy back the stock or to make a cash contribution sufficient to permit the ESOP to repurchase the stock. This may produce a cash flow issue for the company.

The amount of money that must be spent by a closely held corporation to purchase shares from the ESOP participants or the plan is called the repurchase liability. To assist the company in planning for this cash flow drain, an ESOP specialist may perform a repurchase liability study, which predicts the amount of money that will be needed in one or more future plan years.

DEDUCTION AND ALLOCATION LIMITATIONS

Stock bonus plans and ESOPs generally are governed by the profit-sharing plan deduction rules. Therefore, the maximum deductible contribution in a given year is 25 percent of eligible compensation.[57] The definition of eligible compensation for this purpose includes pre-tax elective contributions to 401(k) plans, 403(b) plans and cafeteria plans that may not be part of the participant's normal taxable income for the year.[58] Amounts contributed to the ESOP or other employer plans for pre-tax elective contributions to a 401(k) or 403(b) plan are separately deductible and do not reduce the amount available for employer contributions to the ESOP.[59]

Allocations to a nonleveraged ESOP participant's account are subject to the same limitations under IRC §415 as are allocations to participants' accounts in other defined contribution plans. (Special rules apply to leveraged ESOPs, which are discussed below.) The maximum amount of contributions and forfeitures that may be allocated to a participant's account in an ESOP is the lesser of $57,000 for 2020 (subject to cost-of-living adjustments in future years), or 100 percent of compensation.[60] Compensation for this purpose includes amounts not shown on a Form W-2, such as pre-tax elective contributions to a 401(k) or 403(b) plan and amounts paid into a cafeteria plan.[61]

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[57] IRC §404(a)(3)(A)(i)(I).
[58] IRC §404(a)(12).
[59] IRC §404(n).
[60] IRC §415(c)(1)(A); IRC §415(c)(1)(B).
[61] IRC §415(c)(3).

VOTING RIGHTS

If the stock is a registration-type security—that is, it is publicly traded and registered with the Securities and Exchange Commission—a participant is entitled to vote any shares that are allocated to his or her account. If the stock is not a registration-type security, voting rights must be passed through to participants only with respect to the following issues:

- Approval or disapproval of any corporate merger or consolidation;
- Recapitalization;
- Reclassification;
- Liquidation;
- Dissolution;
- Sale of substantially all assets of a trade or business; or
- Any similar transaction as the Treasury may prescribe in regulations.[62]

Regulations have not yet expanded this listing. In other words, if a stock is closely held, the voting rights will pass through to ESOP participants only in relation to significant changes in the corporation.

The plan may be structured so that participants are permitted to vote the shares of stock allocated to their accounts, and the trustee will vote the unallocated shares. Alternatively, all participants may each get one vote, regardless of the number of shares held, or the participants will vote both the shares allocated to their account and a pro rata portion of the unallocated shares of stock.

7.05: How Leveraged ESOPs Work

A significant distinguishing factor of an ESOP is its ability to borrow, either from the employer or from a third party with the employer's guarantee, to purchase stock. If an ESOP is leveraged, special rules apply to the lending transaction. In addition, the character of the plan changes significantly as other special rules come into play.

When an ESOP borrows to purchase stock, the only security for the loan is the stock that is purchased with its proceeds. The lender may not have any further recourse against the plan or its participants.[63] As a result, most third-party lenders require that the employer guarantee the loan on behalf of the ESOP. This guarantee would normally be a PT, but Treasury and ERISA regulations provide a special exemption for ESOPs.

The ESOP will repay the loan by forwarding amounts contributed by the employer to the lender. Sometimes these contributions and loan payments are made monthly. Often, however, these transactions occur only on an annual basis. Other than with regard to the loan transactions, a leveraged ESOP will operate in the same manner as a nonleveraged ESOP. Therefore, the requirements outlined in the prior section will also apply to a leveraged plan.

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[62] IRC §409(e).
[63] IRC §4975(d)(3); Treas. Reg. §54.4975-7(b)(5).

TYPES OF LOANS

There are two types of loans that are used for ESOP stock acquisitions: direct loans and back-to-back loans.

Direct Loans

In a direct loan transaction, the employer or a financial institution lends money to the plan, and the plan uses that money to buy employer securities. Each year, the employer will contribute an amount sufficient to enable the ESOP to make the loan payment to the lender.

If a financial institution is involved, the employer will usually guarantee the loan. The employer will also promise that its contributions will be sufficient to allow the ESOP to make the loan payments.

EXAMPLE 7-5. Direct Loan. Company A establishes an ESOP. A bank lends the ESOP $5 million to purchase employer stock. The loan is to be repaid in annual installments on a fully amortized basis over ten years at the rate of 8 percent per annum. This will require an annual loan payment by the ESOP to the bank of $745,147. Each year, Company A will contribute an amount equal to at least $745,147 to enable the ESOP to make these payments to the bank. The contribution may be fully tax deductible to Company A.

If the employer makes the loan to the ESOP without using the services of a third-party lender and the stock is to be purchased from an entity other than the company itself, the employer must provide cash to the ESOP to make the purchase. If, however, the stock is to be purchased from the company, the transaction may take place using book entries only. When the loan is made, the employer will make an entry on its books showing an asset equal to the loan receivable from the ESOP and either the issuance of new stock or the decrease of its treasury stock equal to the shares being purchased by the ESOP. On the other side, the ESOP's books will reflect the receipt of the shares of stock as a new asset, with an offsetting book entry equal to the indebtedness to the company. This approach eliminates the need for the actual transfer of funds between the employer and the plan, but also leaves no audit trail other than the book entries. Because of the lack of audit trail, many practitioners prefer the approach in which funds are actually transferred.

Similarly, the employer's contribution of an amount sufficient to enable the ESOP to make a loan payment back to the employer must be made as a cash transaction between the company and the ESOP Trust. The employer will make a contribution to the ESOP. There will be a subsequent payment from the ESOP Trust back to the employer reflecting the payment by the ESOP of principal and interest in an amount equal to the contribution. The employer will receive a tax deduction equal to the contribution and will recognize taxable income for the loan interest received. The net tax deduction will equal the principal portion of the loan repayment. The ESOP's books, in turn, will show the receipt of a contribution, the decrease in its indebtedness, and the payment of loan interest.

Back-to-Back Loans

When a back-to-back loan is used, the employer borrows money from a financial institution. In a separate loan transaction, the employer lends the money to the ESOP, which purchases stock. The security for the loan from the employer to the ESOP is the stock purchased by the ESOP. The security for the loan from the financial institution to the employer is whatever is agreed upon by the employer and the institution; it may include an assignment of the employer's right to the stock in the event of a default by the ESOP.

Each year, the employer will make an actual contribution of cash to the ESOP Trust to fund the required loan payment. The ESOP Trustee will then use this cash to make a loan payment back to the employer.

The employer also makes the required interest and principal payment to the third-party lender. The employer receives a deduction for the contribution to the ESOP, as well as a deduction for the interest paid to the third-party lender on the bank loan to the company. In addition, the employer receives taxable income equal to the interest paid by the ESOP on its loan.

EXAMPLE 7-6. Back-to-Back Loan. Company A borrows $5 million from a bank and secures the loan with its general assets. The loan must be repaid on a fully amortized basis in ten annual installments at 8 percent interest per annum. Company A then lends the $5 million to its ESOP for the purchase of employer securities. The terms of the ESOP loan are identical to those of the third-party loan to the sponsor for purposes of this example.

Each year, Company A will make the required principal and interest payment of $745,147 to the bank. Company A will receive a tax deduction equal to the interest portion of this payment. Company A then will make a contribution of $745,147 to the ESOP, the ESOP Trust will make a loan payment of Company A's loan in the same amount back to the company. Company A will receive a tax deduction for this contribution. In addition, it will recognize taxable income on the interest payment received from the ESOP, which will exactly offset Company A's tax deduction on the interest portion of its payment to the bank (if the loans are being repaid on the exact same terms). Therefore, the net tax deduction to Company A will be its contribution of $745,147.

Although this type of arrangement can be set up with equivalent loans, it is more common for the employer to repay the third-party-lender loan on an accelerated basis without similarly accelerating (or delaying) the repayment of the ESOP loan. Alternatively, the employer can refinance the loan with a different lender on different terms. This provides the employer with more flexibility than it has with a direct loan.

A second reason why back-to-back loans are so popular is the ability of the lender to obtain whatever security it wants for the loan. Because the lender is not involved in the transaction with the ESOP, its recourse is not the stock but the employer's assets (or such selected assets as are agreed upon by the lender and the employer).

ENCUMBRANCE AND RELEASE OF SHARES

The shares purchased by an ESOP act as security for the loan that the ESOP obtains for the purchase. As mentioned above, the IRC prevents the lender to an ESOP from requiring the ESOP to provide any additional security, other than the employer contributions made to the plan for the purpose of making loan payments and the earnings on those contributions. In addition, the only time that the lender may foreclose on the collateral of the ESOP is when the ESOP fails to make a payment on the loan, and then only to the extent of the delinquent payment.[64] As a result, the lender may not call the loan or require additional security if the underlying stock value goes down, even if it means that the loan security is impaired.

At the time the loan is taken, all of the shares purchased with the loan proceeds are encumbered, acting as security for the loan. Encumbered shares are not allocated to participants' accounts but are held in suspense until the encumbrance is released. As principal payments are made on the loan, some of the shares are released from encumbrance. At that time, they are allocated to participants' accounts. If the release is made in connection with a plan contribution, as is usually the case, the shares are allocated in the same manner as the contribution (usually proportionate to compensation). If existing ESOP nonstock assets are used to make a loan payment, the allocation of shares will be in proportion to the nonstock accounts.

ESOP LOANS

As noted above, an ESOP may borrow money for the purpose of acquiring employer securities.[65] The employer may make the loan to the ESOP, or the employer may guarantee a loan made to the ESOP from a third-party lender.

Because of the inherent self-dealing issues involved with an ESOP loan, the Treasury and the Department of Labor (DOL) will scrutinize these transactions. It is recommended that an independent fiduciary approve the loan to ensure that the interests of the plan participants and beneficiaries are being adequately protected.[66]

The ESOP loan must be for the primary benefit of the participants and beneficiaries, even though the employer also receives incidental benefits from the transaction (e.g., cash obtained from the plan's purchase of employer securities).[67] An issue relating to the primary benefit requirement arises when an ESOP is terminated before the exempt loan is fully repaid, and the remaining unallocated shares in the suspense account are sold to repay the loan balance. The IRS has ruled on this issue in several private letter rulings.[68]

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[64] Treas. Reg. §54.4975-7(b)(6).
[65] IRC §4975(d)(3).
[66] Treas. Reg. §54.4975-7(b)(2)(ii) and DOL Reg. §2550.408b-3(b)(2).
[67] Treas. Reg. §54.4975-7(b)(3) and DOL Reg. §2550.408b-3(c).
[68] PLRs 200504040, 200034039, 9640029.

Permissible Uses of Loan Proceeds

The loan proceeds must be used only for the following purposes:

- To acquire qualifying employer securities;
- To repay the exempt loan; or
- To repay a prior exempt loan.[69]

Collateral for Loan

The exempt loan must be without recourse against the ESOP. This means that the bank may not sue the ESOP for collection on default on the loan, except in relation to the collateral pledged. Furthermore, although the ESOP may give collateral for the loan, only two classes of plan assets may be pledged: the qualifying employer securities obtained with the loan, or qualifying employer securities obtained with a prior loan that was repaid with the current loan proceeds.[70] A person entitled to repayment under the loan may not have a right to any assets of the ESOP other than:

- The collateral given on the loan;
- Employer contributions (other than contributions of employer securities) that are made to satisfy the ESOP's obligation under the loan; and
- Earnings attributable to the collateral and the investment of the contributions described above. Previously existing assets in the plan (e.g., when a profit-sharing plan or stock bonus plan is converted into an ESOP) may not be used as collateral on an exempt loan.[71]

EXAMPLE 7-7. Nonrecourse Loan. Bank B lent the Company X ESOP $1,000,000 to acquire 100,000 shares of Company X stock. Company X made contributions for three years to enable the loan payments to be made by the ESOP. At the end of three years the outstanding loan was $500,000. However, the value of the shares still encumbered as security for that loan were only worth $300,000. The ESOP also had cash and investments valued at $2,500,000. Bank B cannot take action to exercise its security rights against the ESOP because the value of the security has decreased below the value of the remaining loan, so long as the payments are not in default. Furthermore, if the ESOP were to terminate or the payments were to go into default, Bank B could take possession of the employer stock that was securing the loan, but would have no right to demand payment by the ESOP from the other ESOP assets for the portion of the loan no longer covered by the security.

[69] Treas. Reg. §54.4975-7(b)(4).
[70] Treas. Reg. §54.4975-7(b)(5).
[71] This portion of the rule does not apply to an IRC §1042 transaction.

Suspense Account for Unallocated Securities

While qualifying employer securities are held by the plan as collateral on an exempt loan, the plan maintains a suspense account with respect to such securities. The securities must be released during the repayment period of the loan, in a manner that reflects the portion of the loan that has been repaid. Release of securities may be based on both the principal and interest payments made under the loan, or solely on the principal payments.[72] Where only principal payments are taken into account to determine the rate at which securities are released, the repayment term on the loan may not exceed ten years and the payments must be equal. In addition, if only principal payments are taken into account to release securities from the suspense account, and the loan is renewed, extended or refinanced, the sum of the expired duration of the exempt loan, the renewal period, the extension period, and the duration of a new exempt loan may not exceed ten years.[73]

Sale of Collateralized Stock to Repay Loan

If an ESOP is terminating, or there is a spin-off or sale transaction involving a division or subsidiary of the employer, the IRS has permitted the remaining securities in the suspense account (or a portion thereof) to be sold and the proceeds of the sale to be used to repay the exempt loan (or corresponding portion of the exempt loan).[74]

Use of Corporate Dividends to Repay Loan

Earnings on the collateral for an ESOP exempt loan may be used to make repayments on that loan. Earnings on the collateral includes dividends paid on the employer securities held in the suspense account (the unallocated shares).[75]

Establishing the ESOP Loan Payment Schedule

When an exempt loan is negotiated, the repayment schedule is typically designed to provide for the release of stock from the suspense account in a manner that is consistent with a specific projected level of benefits (i.e., objectives regarding benefit accruals under the plan) and/or participant contributions (e.g., if employer stock will be allocated as matching contributions). These expectations are also affected by the contribution limitations under IRC §415(c) and whether projected releases from the suspense account will satisfy these limitations.

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[72] Treas. Reg. §54.4975-7(b)(8).
[73] Treas. Reg. §54.4975-7(b)(8)(ii).
[74] PLR 9416043 (ESOP's termination), PLR 9417032 (ESOP's termination), PLR 9437035 (sale of stock following merger of companies), PLR 9507031 (spin-off/termination transaction), PLR 200006054 (successive stock sales result in reconstituted controlled group and termination/merger of ESOP and repayment of outstanding exempt loans with proceeds from sale of unallocated shares), PLR 200034039 (proceeds from sale of unallocated shares used to pay off loan, remainder allocated to account balances as investment earnings).
[75] Treas. Reg. §54.4975-7(b)(5)(iii).

SPECIAL DEDUCTION AND ALLOCATION RULES FOR LEVERAGED ESOPS

One of the crucial differences between leveraged and nonleveraged ESOPs is the deduction limit. The deduction limit for ESOPs and stock bonus plans is equal to 25 percent of eligible compensation.[76] However, a special limit applies for a leveraged ESOP. This limit permits the deduction of up to 25 percent of eligible compensation for principal payments on the loan. In addition, a leveraged ESOP may deduct any amount contributed to pay loan interest.[77] The 25 percent limitation for the leveraged ESOP does not take into account contributions to other defined contribution plans maintained by the employer. Those contributions are subject to the normal 25 percent limit, which is entirely separate.[78] Note this additional 25 percent deduction for ESOPs is only allowed if the employer is a C Corporation.

EXAMPLE 7-8. Deduction for Leveraged ESOP Contributions. An employer maintains three plans: Plan MP is a money purchase pension plan, Plan K is a 401(k) plan and Plan LE is a leveraged ESOP. The annual employer contributions to Plans MP and K (disregarding pre-tax elective contributions contributed to Plan K) total less than 25 percent of aggregate participant compensation.

The sum of the employer contributions to Plan MP and Plan K are subject to the defined contribution plan 25 percent deduction limit under IRC §404(a)(3). Thus, the total contribution to these plans is fully deductible because it does not exceed this 25 percent limit. The pre-tax elective contributions contributed to Plan K are deductible in full, pursuant to IRC §404(n).

The contributions to Plan LE, which are applied to payments on the ESOP's exempt loan, are deductible under the rules of IRC §404(a)(9). Thus, the principal payments are deductible up to 25 percent of aggregate participant compensation and the interest is fully deductible.[79] The 25 percent limit under IRC §404(a)(9) is separate from the 25 percent limit under IRC §404(a)(3). Thus, the employer contributions to Plan MP and Plan K are not combined with the contributions under Plan LE under a single 25 percent deduction limit.[80]

To permit the allocation to participants' accounts of the stock released from encumbrance, the IRC §415 limitation on such allocations is also expanded for a leveraged ESOP. An ESOP may have its plan document drafted to define annual additions to be the lesser of the contributions used to make loan payments, or the fair market value of shares released from encumbrance.[81]

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76 IRC §404(a)(3).
77 IRC §404(a)(9).
78 Q&A-22 of the ABA Q&A with the IRS on May 7, 2004. See the ABA website.
79 IRC §404(a)(9)(A) and (B).
80 PLR 200436015.
81 IRC §415(c)(6).

As a result of these provisions, ESOP sponsors may contribute significantly more for the benefit of their employees to a leveraged plan than would be available in other types of defined contribution plans.

7.06: Dividends

When a corporation declares and issues a dividend to its shareholders, this payment is not tax deductible. Nonetheless, the receipt of dividends generally is considered to be taxable income to the shareholders. Because the corporation receives no offsetting deduction, the effect is that tax is paid at both the corporate and the individual shareholder levels.

Dividends paid to an ESOP sponsored by a C corporation, however, are deductible if the following four additional requirements are met:

1. The dividend must be used either to repay an ESOP loan, or each participant may elect for the dividend on his or her shares to be:

- Paid directly to the participant in cash;
- Paid to the plan and then distributed to the participant in cash within 90 days after the close of the plan year in which the dividend was received;
- Paid directly to the participant, or paid to the plan and reinvested in qualifying employer securities at the election of the participant; or
- Reinvested in employer securities.[82]

2. If the ESOP currently has a loan, the dividends are deductible only if they are used to repay the loan whose proceeds acquired the securities to which the dividends relate. Dividends on shares allocated to participant accounts can also be used to repay an ESOP loan, as long as shares worth the fair market value of the cash dividends are released from encumbrance and allocated to the participants' accounts.

3. The dividends must be reasonable and must be characterized as dividends under state law. One method of determining whether the dividends are reasonable is to compare the dividend rate with that of comparable publicly traded companies. Furthermore, the ESOP must have been the owner of the shares on the dividend record date, and either the corporation paying the dividend or a member of the corporation's controlled group must sponsor the ESOP.

4. If the ESOP sponsor is subject to the alternative minimum tax calculation, the deduction of dividends is a preference item. Therefore, the dividends must be added back to the company's taxable income in calculating the alternative minimum tax.

If the ESOP owns all of the stock of the C corporation sponsor (or all of the stock that has dividend rights), the effect of these special rules is to make the dividend totally tax deductible. If the ESOP

[82] IRC §404(k).

owns only a portion of the employer's stock, the portion of the dividend paid to the ESOP will be deductible, while the portion that is paid to the other shareholders will not be deductible.

ELECTING REINVESTMENT OF DIVIDENDS IN EMPLOYER SECURITIES

Election Requirements

The participant must have a reasonable amount of time to decide whether the dividends should be paid or reinvested before the dividend is paid or distributed to the participant.[83] There must also be a reasonable opportunity to change a dividend election at least annually. For example, a plan might provide that a participant's election must be made within the first quarter of each year, and that election applies to all dividends paid in that year. If the terms of the plan are changed regarding the manner in which dividends are paid or distributed, there must be a reasonable opportunity to make an election under the new terms prior to the date on which the first dividend subject to those terms is paid or distributed.

Default Election

The plan also may have a default election if an affirmative election is not made by the participant. For example, the plan might provide that the participant is deemed to have elected distribution of the dividend in the absence of an affirmative election.[84] An ESOP must contain plan language permitting participants to make the dividend election in order for the dividends to be deductible.

RULES REGARDING DEDUCTIBILITY UNDER IRC §404(K)

The deduction for dividends available to C corporations is in addition to the deduction taken under IRC §404 for other employer contributions to the plan. Thus, the deduction limits outlined in IRC §404, with respect to employer contributions, are not affected by the amount of dividends the corporation is deducting pursuant to IRC §404(k).

A C corporation is not entitled to a deduction under IRC §404(k) unless the dividends are being paid on employer securities as defined in IRC §409(l). If a qualified plan (even an ESOP) happens to hold stock in a corporation that does not satisfy the definition of employer securities, dividends paid on that stock would not be eligible for a deduction even if the requirements of IRC §404(k) are otherwise satisfied.

TREATMENT OF DIVIDENDS UNDER THE PLAN

Dividends are not annual additions under IRC §415, pre-tax elective contributions under IRC §§401(k) or 402(g), or after-tax employee contributions under IRC §401(m).[85] This is true even if the dividends are reinvested in employer securities in lieu of being distributed to the participant. If dividends are distributed, they are not subject to the 10 percent tax on early

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[83] Q&A-3 of Notice 2002-2, 2002-2 IRB 285.
[84] Notice 2002-2, 2002-2 IRB 285 Q&A–3, last sentence.
[85] Notice 2002-2, Q&A-6, Treas. Reg. §1.401(k)-1(a)(2)(iii).

distribution under IRC §72(t),[86] and they are not eligible for rollover under IRC §402(c), even if the dividends are distributed at the same time as amounts that constitute an eligible rollover distribution.[87] Furthermore, the consent rules under IRC §411(a)(11) are not applicable to dividends distributed pursuant to IRC §404(k), and the IRC §401(k) distribution restrictions are not applicable, even if the dividends are paid on employer securities purchased with pre-tax elective contributions.

Once dividends are reinvested in employer securities, they lose their identity as IRC §404(k) dividends and are treated as earnings in the same manner as dividends for which no election is provided.[88] Thus, if a participant receives a distribution before age 59½, the portion of the distribution attributable to dividends that were reinvested in employer securities pursuant to an election described in IRC §404(k)(2)(A)(iii) is subject to the IRC §72(t) penalty and is eligible for rollover (if paid as part of an eligible rollover distribution).

To be deductible, dividends retained in the plan at the employee's election must be reinvested in employer securities. However, there is no specific requirement in IRC §404(k) that the reinvested dividends must remain in the form of employer securities for the duration of an employee's participation in the plan. Therefore, they can presumably be exchanged for other plan investments that are available. The IRS noted in a private letter ruling that once the dividends were allocated to a participant's account and reinvested in employer securities, pursuant to the participant's election, they became subject to the participant's investment direction and could be transferred into other investment options available under the plan.[89]

RIGHT TO TAKE DISTRIBUTION OF DIVIDENDS MUST BE EXERCISED BEFORE 401(K) HARDSHIP WITHDRAWAL IS ELECTED

The Treasury Regulations require a participant to take all non-hardship distributions available from the employer's plans before taking a hardship withdrawal under a 401(k) plan.[90] This is required before the 401(k) hardship withdrawal can be treated as necessary to satisfy an immediate and heavy financial need of the employee. The right to receive ESOP dividends is a distribution option that must be exhausted first.[91] Thus, if a participant has the right to elect a distribution of the dividends versus a reinvestment of the dividends in employer securities, the distribution must be elected as a condition for requesting a 401(k) hardship withdrawal to the extent such an election is currently available at the time the hardship withdrawal is being requested.

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[86] IRC §72(t)(2)(A)(vi).
[87] Treas. Reg. §1.402(c)-2, Q&A-4.
[88] Notice 2002-2, 2002-2 IRB 285, Q&A-7.
[89] PLR 200350017.
[90] Treas. Reg. §1.401(k)-1(d)(3)(iv)(C) and (E).
[91] Notice 2002-4, 2002-2 IRB 298, Q&A-8.

REINVESTED DISTRIBUTABLE DIVIDENDS MUST BE FULLY VESTED

If an employee is allowed to elect between a distribution of the dividend or reinvestment in employer securities, any dividends reinvested pursuant to such election must be 100 percent vested, even if the participant is not otherwise 100 percent vested under the plan's vesting schedule.[92] A plan may satisfy this requirement in one of two ways:

1. Provide that reinvested dividends are fully vested, even if the participant is not fully vested in the employer securities on which the dividends are paid; or
2. Offer an election to reinvest dividends only to participants who are 100 percent vested.

An employer may not wish to use the first option, because that option could require separate accounting to properly apply the plan's vesting schedule to the participant's account benefit. If the second option is chosen, the participants who are not 100 percent vested would be required to receive distribution of the deductible dividends no later than 90 days after the dividends are paid by the corporation to the ESOP, rather than having an option to have the dividends reinvested in employer securities (if the corporation wants a deduction for the dividend).

DEDUCTIBLE DIVIDENDS PAYABLE TO PARTICIPANTS REPORTED AS DIVIDENDS

Deductible dividends under IRC §404(k) that are distributed to the participants or beneficiaries directly from the plan sponsor are reported on Form 1099-DIV. If the dividend is paid from the ESOP Trust account, the dividend is to be reported on Form 1099-R with a Tax Code of U.

7.07: S Corporation ESOPs

GENERAL DIFFERENCES BETWEEN S CORPORATION ESOPS AND C CORPORATION ESOPS

As noted earlier in this chapter, the Code was amended in 1998 to permit S corporations to sponsor ESOPs. Generally, the rules for **S corporation ESOPs** are the same as for those sponsored by C corporations, with these few exceptions:

- First and foremost, because an S corporation is a "pass-through" entity for tax purposes, there are no taxes paid at the corporate level. The shareholders are credited with the income, losses and deductions of the S corporation. To the extent that the ESOP is a shareholder of an S corporation, the ESOP's portion of any income will be paid to a tax exempt entity. Therefore, that portion will not be subject to any taxation.
- An S corporation ESOP may not provide for deductible dividends. Furthermore, because of the limitations on the number of shareholders in an S corporation, ESOPs sponsored

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[92] IRC §404(k)(7), Notice 2002-2, 2002-2 IRB 285, Q&A-9.

by these entities do not have to–and generally do not–permit distributions in stock. Because stock distributions are not permitted, there is no need to provide put option rights in an S corporation ESOP. If, however, the S corporation ESOP does permit distributions of its stock to the participants, the application of special basis recovery rules for S corporations may limit the ability to defer the tax on net unrealized appreciation on those distributions, as there are in such distributions from a non-S corporation plan.[93]

- Owners of S corporation stock may not take advantage of the tax deferral on sales of stock to an ESOP under IRC §1042.[94] S corporations may not take advantage of the expanded deduction and allocation limits under IRC §§404 and 415 that are provided to leveraged ESOPs sponsored by C corporations.[95]

LIMITATION ON ALLOCATIONS TO DISQUALIFIED PERSONS

One significant difference between S corporation ESOPs and those of C corporations relates to a special limitation on allocations under IRC §409(p). At one time, several small corporations that employed only shareholders utilized the S corporation ESOP rules to operate their corporations as tax-exempt entities. Because they had no rank-and-file employees, the benefits of employee ownership were not experienced by anyone other than those who originally owned the company. As a means of closing this loophole, Congress enacted §409(p) as part of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), effective March 14, 2001, for new plans, and January 1, 2005, for plans in existence before §409(p) was added to the IRC.

Under these rules, an S corporation ESOP must provide that no portion of the plan attributable to (or allocable in lieu of) employer securities may accrue during a “nonallocation year” to “disqualified persons” (DQPs). Such an allocation is called a **prohibited allocation**. As daunting as this vague provision may appear at first, the actual process of applying these rules can be even more complex, and only a general description is provided here.

An individual is a **disqualified person** if he or she owns at least 10 percent of the stock in the ESOP, or his or her family owns or is deemed to own at least 20 percent of the stock in the ESOP. The amount of stock that someone is deemed to own is determined through a complicated process that artificially allocates shares held in suspense, and also potentially takes into account stock options and an approximated stock value equivalent of nonqualified deferred compensation (also called **synthetic equity**).

To apply these complex rules, the plan administrator must take the following six steps:

1. Identify each participant’s deemed ownership of the S corporation, both as an individual and as a participant in the ESOP;
2. Determine who is a DQP;
3. Determine who are members of the DQP’s family unit;

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[93] IRC §1367.
[94] IRC §1042(c)(1)(A).
[95] IRC §§404(a)(9)(C), 415(c)(6).

4. Determine the level of **deemed-owned shares** and *synthetic equity* owned by each DQP and his or her family members;
5. Determine whether the deemed ownership of DQPs and family is sufficient to cause the plan year to be a "nonallocation year"; and
6. Apply the limitations of IRC §409(p) as needed to avoid a prohibited allocation.

The result of these calculations is that if a sufficiently small group of individuals has a sizable enough ownership in the S corporation, either inside the ESOP or in combination of ESOP and non-ESOP shares, those individuals may not get any allocations in the ESOP. Section 409(p) must be passed every day in the plan year.

The penalty for making a prohibited allocation is more than significant. If there is a prohibited allocation:

- The amount of the prohibited allocation is treated as distributed to the disqualified person;[96]
- The S corporation is subject to a 50 percent excise tax;[97]
- The ESOP is no longer eligible for the PTE that permits it to be a leveraged ESOP, which would cause any existing ESOP loan to be subject to a 15 percent excise tax;[98] and
- The plan no longer qualifies as an ESOP, which means that its earnings constitute unrelated business taxable income.

Furthermore, the regulations provide that a violation of these rules disqualifies the plan.[99]

Definition of Deemed-Owned Shares

For purposes of determining an individual's ownership in relation to §409(p), the rules use a concept called deemed-owned shares or DOS. A participant's DOS are:

- shares of stock of the S corporation that are allocated to a participant's account under the ESOP, plus
- the participant's share of the unallocated stock held by the ESOP (i.e., shares held in a suspense account pursuant to the exempt loan provisions under IRC §4975(d)(3)).[100]

The participant's share of unallocated stock is determined on the basis of the shares released and allocated from the suspense account for the most recently ended plan year for which there was such a release and allocation.[101] If there has been no such prior release and allocation, then the proportion is determined using a reasonable estimate of the shares that would be released and allocated in the first year of loan repayment. Note that this determination of the participant's proportionate share of unallocated stock is for purposes of IRC §409(p) only; no actual allocation of those amounts occurs until the stock is released from suspense.

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96 IRC §409(p)(2)(A).
97 IRC §4979A(a)(3).
98 Treas. Reg. §1.409(p)-1(b)(2)(iv)(B).
99 *Id.*
100 Code §409(p)(4)(C)(i).
101 Code §409(p)(4)(C)(ii) and Treasury regulations §1.409(p)-1(e).

Definition of Family Unit

For purposes of determining whether the participant and his or her family owns sufficient DOS to invoke the limitations under §409(p), the "family unit" includes the following four categories of individuals:

1. The participant's spouse;
2. An ancestor or lineal descendant of the participant (e.g., parents, grandparents, children, grandchildren) or of the participant's spouse (e.g., parents-in-law, a spouse's grandparents);
3. Siblings of the participant or the participant's spouse, and any lineal descendant of a sibling (e.g., nieces and nephews of the participant); and
4. The spouse of any individual described in (2) and (3).[102]

This is a much broader definition of family than is used under any other attribution rules that apply to qualified plan requirements.[103] This definition includes the individual and all family members of the individual.

Definition of a Nonallocation Year

If there is a nonallocation year, then the limitations of §409(p) are invoked, and no allocation may be made to a DQP. A nonallocation year is any year in which DQPs in the aggregate own 50 percent or more of the S corporation, considering such individuals' ownership both inside or outside the ESOP, and taking into account "synthetic equity" in the S corporation. Synthetic equity is the term given by §409(p) to benefits provided by the corporation to individuals in the form of certain types of nonqualified deferred compensation and restricted property. Basically, §409(p) looks at whether ownership of the S corporation is concentrated in the hands of very few individuals or families.

7.08: Special Tax Rules for Distributions of Employer Securities

An employee's distribution may include employer securities and cash, or may be entirely in the form of employer securities. This is possible not only in an ESOP or stock bonus plan, but in any qualified plan that invests in employer securities and provides for distribution in the form of such securities. When a distribution includes employer securities, certain special tax rules are applicable.

[102] Code §409(p)(4)(D) and Treasury regulations §1.409(p)-1(d)(2).
[103] Code §318 and Code §1563.

INCOME TAX WITHHOLDING RULES

Special rules apply to determine income tax withholding requirements on a distribution that includes employer securities. These rules prevent the securities (or a portion of the securities) from having to be sold to satisfy any withholding obligation.

Distribution Solely in Employer Securities

If a distribution consists solely of employer securities, no withholding applies, even if the distribution is an eligible rollover distribution and would otherwise be subject to 20 percent mandatory withholding.[104] This same rule applies if the distribution consists of employer securities and cash, and the cash does not exceed $200.

Distribution Partly in Cash (or Other Property)

If the cash included in the distribution exceeds $200, or property other than employer securities is included in the distribution, the normal withholding rules apply. To compute the applicable withholding amount, the value of the employer securities is included, but the withholding obligation will not exceed the cash and other property included in the distribution. NUA that is excludable from gross income is disregarded to determine the value of the employer securities included in the distribution that is subject to withholding.[105]

EXAMPLE 7-09. Cash Portion of Distribution Sufficient to Pay Withholding. A lump sum distribution from a profit-sharing plan consists partly of employer securities and partly of cash. The employer securities portion (excluding NUA) is $15,000, and the cash portion is $40,000 (for a total of $55,000). Because the distribution is an eligible rollover distribution, the 20 percent withholding rate applies on any portion of the distribution that is not directly rolled over. The participant does not elect a direct rollover. The withholding is $11,000 (i.e., 20% x $55,000) because the value of the employer securities is included in the computation. The withholding is taken from the cash portion of the distribution.

EXAMPLE 7-10. Cash Portion of Distribution Insufficient to Pay Withholding. Let us change the facts in the prior example. Suppose the employer securities portion (excluding NUA) is $120,000 and the cash portion is $15,000. Now the 20% withholding liability would be $27,000 (20% x $135,000). Because that exceeds the cash portion of the distribution, the withholding liability is reduced to $15,000. All of the cash is transmitted to the IRS for withholding.

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[104] IRC §3405(e)(8) and Treas. Reg. §31.3405(c)-1, Q&A-11.
[105] IRC §3405(e)(1)(B)(ii), Treas. Reg. §31.3405(c)-1, Q&A-12, and IRS Notice 93-3, 1993-1 C.B. 293.

TAX CONSEQUENCES OF SELLING THE DISTRIBUTED EMPLOYER SECURITIES

When a former participant who has received employer securities in a distribution later sells the securities, a portion of the proceeds from that sale is taxable if the selling price exceeds the individual's cost basis in the securities. The cost basis is the amount the individual included in income when he or she received the securities as a plan distribution (plus any portion of the securities that were treated as a return of the individual's basis in the plan under the IRC §72 basis recovery rules). NUA that is excluded from gross income is not part of the individual's cost basis for purposes of determining the tax consequences on a sale of the securities.

EXAMPLE 7-11. Computation of Gain. M receives a lump sum distribution from M's employer's profit-sharing plan. M's distribution consisted of $40,000 in cash and employer securities valued at $60,000. The NUA in the securities was $25,000, so the taxable portion of the securities was $35,000. M excluded the NUA from gross income. M's cost basis in the securities is $35,000. Two years later, M sells the securities for $78,000. M's taxable gain on the sale is $78,000 minus $35,000, or $43,000.

EXAMPLE 7-12. Gain on Sale is Less Than NUA. Suppose in the above example that M sells the stock for $50,000, rather than for $78,000. M still has gain, because M's basis in the securities is only $35,000. M's gain is only $15,000. M does not take a loss, because M had not included the NUA portion in income at the time of distribution. Had M done so, M's basis would have been $60,000, and M would have incurred a loss of $10,000.

EXAMPLE 7-13. NUA Not Excluded. Assume the same facts as under Example 7-11, except that M elected not to exclude the NUA from taxable income. In that case, M recognized in income in the year of the distribution the full value ($60,000) of the employer securities that were included in the lump sum distribution. M's cost basis in the securities is $60,000, rather than $35,000. When M subsequently sells the shares, the taxable gain is $78,000 minus $60,000, or $18,000. An individual might elect to include in income the full value of the distributed employer securities because the individual's effective tax rate is low (e.g., losses in that taxable year minimize the tax consequences), or because the distribution qualifies for income averaging treatment under IRC §402(d).

Plan's Basis in Distributed Shares Not Relevant in Calculating the Distributee's Basis in Such Shares

There are four methods for calculating the basis of employer securities in the hands of the plan:

1. The earmarking method;
2. The 12-month allocation method;
3. The single security type method; and
4. The average cost method.[106]

The method used by the plan affects the plan's determination of the NUA included in any distribution of employer securities from such plan. Some of these methods may result in some employer securities held by the plan having a different cost basis than other employer securities held by the plan.

When the employee later sells the shares, however, all of the shares will have the same cost basis with regard to that employee, regardless of how the plan's cost basis was calculated.[107] The cost basis allocated to each share in the hands of the employee is equal to the total NUA at the time of the initial distribution, divided by the number of shares distributed.

EXAMPLE 7-14. Participant's Basis on Distribution. J's account balance consists of 1,000 shares of employer securities. Under the plan's accounting method, the shares have varying cost bases, as follows:

	Number of shares	Cost per share	Total basis
	400	$25	$10,000
	350	$30	$10,500
	250	$40	$10,000
Total	**1,000**	**n/a**	**$30,500**

J receives the 1,000 shares in a lump sum distribution. At the time of distribution, the shares are valued at $50 per share, for a total value of $50,000. J's NUA is $19,500 (i.e., $50,000 minus $30,500). J excludes the NUA from gross income. J's total basis in the 1,000 shares is $30,500 (i.e., $50,000 total value minus $19,500 NUA). This is divided among the shares equally. Thus, for purposes of determining J's gain or loss on a subsequent disposition of any of these shares, each share's basis in J's hands is $30.50 (i.e., $30,500 divided by 1,000 shares). J may not elect to treat the 1,000 shares as having the same bases of $25, $30, and $40 as they had while held by the trust (as reflected in the above table).

[106] Treas. Reg. §1.402(a)-1(b)(2).
[107] Rev. Rul. 57-514, 1957-2 C.B. 261.

Capital Gain Treatment on Sale Proceeds

To the extent the taxable gain on the sale of the employer securities does not exceed the NUA that was previously excluded from income, the gain is taxed as long-term capital gain, regardless of the individual's actual holding period and regardless of the plan's holding period.[108] To the extent the taxable gain exceeds the previously excluded NUA, the characterization of the gain as long-term or short-term capital gain depends on the individual's actual holding period. The individual's holding period begins on the date following the date the trustee of the plan delivers the stock certificates to the transfer agent with written instructions to reissue the certificates in the name of the individual.[109]

7.09: Review of Key Concepts

- What is a stock bonus plan?
- What are the primary characteristics of an ESOP?
- What are the special rules applicable to distributions and taxation of distributions of employer stock?
- Explain the diversification rules, including who must be eligible, the timing of the diversification, and the amount of the diversification.
- What is a leveraged ESOP?
- How is a leveraged ESOP different from a nonleveraged ESOP?
- What are the dividend deduction rules applicable to ESOPs?
- What are the differences between the rules applicable to C-Corporation ESOPs and S-corporation ESOPs?
- Discuss the reasons a plan sponsor might establish an ESOP.
- Explain the rules regarding the IRC §1042 election and allocation restrictions.
- State the mechanics of the IRS §409(p) rules and how they impact an S-Corporation ESOP.

7.10: For Practice – True or False

1. To satisfy the diversification requirements, a plan must offer three investment alternatives other than employer stock.
2. Leveraged ESOPs must take a loan from a commercial source.
3. ESOPs cannot be integrated using permitted disparity.
4. For publicly traded stock, voting rights must be passed through to the participant in the ESOP.
5. For closely held stock, voting rights must be passed through to the participant in the ESOP.
6. Stock bonus plans may make distributions in employer stock.

[108] Treas. Reg. §1.402(a)-1(b)(1)(i), Rev. Rul. 81-122, 1981-1 C.B. 202, and IRS Notice 98-24, 1998-17 IRB 5.
[109] Rev. Rul. 82-75, 1982-1 C.B. 116.

7. ESOPs invest primarily in employer stock.
8. Many employers can contribute more to an ESOP than to other defined contribution plans.
9. A participant who is age 55 is eligible for IRC §401(a)(28) diversification.
10. Dividends paid to an ESOP may be tax deductible to the employer.
11. If an ESOP makes a prohibited allocation or accrual, an excise tax equal to 50 percent of the accrual is imposed on the S corporation, and the disqualified person is deemed to have received a distribution in the amount of the prohibited allocation.
12. The definition of family used in IRC §409(p) is much broader than other definitions of family used under other attribution rules that apply to qualified plan requirements.

7.11: Sample Test Questions

1. All of the following statements regarding ESOPs are TRUE, EXCEPT:
   A. A money purchase pension plan can include an ESOP provision.
   B. A 401(k) plan can include an ESOP provision.
   C. An ESOP can allocate contributions using permitted disparity.
   D. The deduction limit may exceed 25 percent of compensation in some ESOPs.
   E. IRC §415 limits may be higher in ESOPs than in other defined contribution plans.

2. All of the following statements regarding ESOP diversification under IRC §401(a)(28) are TRUE, EXCEPT:

   A. The right to diversify must be provided annually for six years.
   B. Qualified participants must be able to diversify a total of 25 percent of their account balance for five years, and 50 percent in the sixth year.
   C. Diversification must be provided at age 55 and ten years of service.
   D. In the final election year, the participant must be able to diversify 50 percent of his or her account balance invested in employer stock.
   E. Diversification is based on the number of shares, not on the value of those shares.

3. Based on the following information, determine the number of shares currently available for diversification.

- Participant A's account contains 20,000 shares valued at $2 per share.
- Participant A is age 59 with 20 years of participation.
- Two years ago, Participant A diversified 1,500 shares valued at $4 per share.

   A. 2,750
   B. 3,500
   C. 3,875
   D. 5,000
   E. 5,375

4. All of the following statements regarding leveraged ESOPs are TRUE, EXCEPT:

   A. ESOP loans may be back-to-back loans.

B. The shares purchased by the ESOP are security for the loan.
C. Loan proceeds may be used to repay another exempt loan.
D. Employer securities that are used as collateral are allocated to eligible participants.
E. Dividends may be used to repay the loan.

5. All of the following statements regarding calculating net unrealized appreciation (NUA) on a stock distribution are TRUE, EXCEPT:

   A. It is the difference between the value of the employer stock at the time of distribution minus the plan’s cost basis in the stock.
   B. If the employer stock is rolled over to another qualified plan, the recipient plan’s cost basis is equal to the value of the employer stock at the date of rollover.
   C. A participant who received a lump sum distribution that includes employer stock, may elect to exclude from gross income the entire NUA.
   D. A participant who receives a distribution prior to age 59½ and includes employer stock will be subject to the 10% tax on early distribution on the NUA portion that is excluded from income.
   E. If the value of the employer stock at the time of distributions is less than the plan’s cost basis, the NUA is zero.

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

7.12: Solutions to True or False Questions

1. False. A plan need not offer other investment alternatives — it could instead offer a cash distribution and/or a transfer to another qualified plan that offers such investment alternatives.
2. False. The loan can come from any source, as long as it is an arms-length transaction.
3. True.
4. True.
5. False. Only on certain issues must voting rights be passed through to shareholders.
6. True.
7. True.
8. True.
9. False. A participant must be age 55 with ten years of plan participation to be subject to the diversification requirements of IRC §401(a)(28).
10. True.
11. True.
12. True

7.13: Solutions to Sample Test Questions

1. The answer is **C**. ESOPs may not use permitted disparity in their allocation formulas.
2. The answer is **C**. Diversification is available to participants age 55 with ten years of participation, not service.
3. The answer is **C**. Participant A is eligible to diversify a total of 25 percent of the account balance. The total balance is the current balance of 20,000 shares plus the 1,500 shares that were diversified two years ago for a total of 21,500 shares. 25 percent of 21,500 shares is 5,375, less the 1,500 already diversified, leaves 3,875 available for diversification.
4. The answer is **D**. Employer securities that are used as collateral must be held in a suspense account and are not allocated securities.
5. The answer is **D**. The participant is not subject to the 10% tax on early distribution on the NUA that is excluded from income. The penalty only applies to the taxable portion of the distribution.

CHAPTER 8:

FIDUCIARY STANDARDS

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8.01: Key Terms

- 20 percent civil penalty
- 3(16) fiduciary
- Fiduciary
- Funding policy
- 3(21) fiduciary
- 3(38) fiduciary
- Administrative functions
- Applicable recovery amount
- Co-fiduciary liability
- Custodian
- Directed trustee
- Diversification standard
- Exclusive purpose rule
- Fidelity bond
- Guaranteed benefit policy exception
- Investment manager
- Investment policy statement
- Ministerial functions
- Named fiduciary
- Plan administrator
- Prudence standard
- Settlor functions
- Successor fiduciary
- Trustee

8.02: Definition of Fiduciary

Most of the duties and responsibilities under Title I of ERISA must be carried out by a fiduciary. A plan will generally have more than one fiduciary, and a particular fiduciary may have responsibility for only certain aspects of the plan. ERISA §3(21) defines a fiduciary as someone who is in at least one of the following categories:

- Exercising discretionary authority or discretionary control of the management of the plan;
- Possessing discretionary authority or discretionary control over the administration of the plan;
- Exercising any authority or control over the assets of the plan; or
- Rendering investment advice for a fee (or has any authority or responsibility to do so.)

This definition allows some functions of a 3(21) fiduciary to be *exercised* by the fiduciary and other functions involve having the *authority* to take certain actions regardless of whether that action was taken.

MANAGEMENT

The above definition does not make a distinction between management of plan and administration of the plan. Therefore, let us consider that management of the plan is an oversight function and allocation of responsibilities. These functions include:

- Authority to hire or fire other fiduciaries (e.g., trustee, investment manager, investment adviser, administrative committee), or/or the responsibility to evaluate the performance of such fiduciaries;
- Authority to hire or fire other service providers that are traditionally not fiduciaries (e.g., third party administrator, investment product issuer, recordkeeper, attorney, document provider, accountant), and/or the responsibility to evaluate the performance of such fiduciaries;
- Authority to negotiate fees for services provided to the plan;

- Authority to decide whether investment decisions will be made by the trustee, by an investment manager, by plan participants, or a combination of such persons; or
- Authority to decide if plan investments will be participant-directed, the authority to determine which investment options will be made available to participants or who will make such a decision.

If a person exercises any discretionary authority or control over the management of the plan, he or she is a fiduciary. Note that the person must exercise or possess discretion in order for the 3(21) fiduciary status to be conveyed. The plan sponsor, in many cases, is the one who has the responsibility of management of the plan and thus is a fiduciary.

ADMINISTRATION

Administration of the plan is the day-to-day operation of the plan. This includes:

- Responsibility over satisfying the ERISA reporting and disclosure obligations of the plan;
- Responsibility over determining who is eligible for the plan;
- Responsibility over proper administration of the plan's allocation formula to ensure that allocations are properly made to participants' accounts, and to ensure that proper records are maintained to support the plan's benefit determinations;
- Authority to decide on claims for benefits;
- Authority to settle disputes (e.g., appeal of denial of benefits);
- Authority to interpret ambiguous plan terms; or
- Responsibility over determining whether a domestic relations order is a QDRO.

A person is a fiduciary if he or she has any discretionary authority or responsibility in the administration of the plan. Note that the person must exercise or possess discretion in order for the 3(21) fiduciary status to be conveyed.

Ministerial Functions Not Fiduciary in Nature

A necessary consequence of administering a plan is to have a number of ministerial functions performed every year. Although the selection of a service provider is a fiduciary action relating to the administration of the plan, a service provider who becomes responsible for carrying out the ministerial functions relating to the administration of a plan is not a fiduciary merely because of such responsibilities. If a person performs functions within a framework of policies, interpretations, rules, practices and procedures made by other persons, such person does not have discretionary authority over plan management or administration and is not exercising any authority or control over the plan's assets.

The DOL has provided the following list of administrative functions that are ministerial functions (and, therefore, not fiduciary activities):

- Application of rules to determine who is eligible for participation;
- Calculation of services and compensation to determine benefits;
- Preparation of employee communications materials (e.g., summary plan description (SPD));
- Maintenance of service and employment records;
- Preparation of reports to the government agencies (e.g., Form 5500);

- Calculation of benefits;
- Orientation of new participants, and advising participants of their rights and options under the plan;
- Collection of contributions;
- Preparation of participant benefit statements;
- Processing of claims; and
- Making recommendations to a person with decision-making authority.[1]

For example, a benefit supervisor whose function is to calculate the amount of benefits under the plan's formula would be performing only ministerial functions. So long as the benefit supervisor's duties are limited to such calculations, the benefit supervisor is not a fiduciary. On the other hand, if the plan gives the benefit supervisor the final authority to authorize or disallow benefit payments if a dispute exists as to the interpretation of plan provisions relating to eligibility for benefits, the supervisor would have the requisite authority over plan administration and management to be considered a fiduciary.[2]

AUTHORITY OR CONTROL OVER PLAN ASSETS

This portion of the **3(21) fiduciary** definition involves the actual investment decisions with respect to the assets of the plan. Thus, the trustee of the plan is a 3(21) fiduciary by virtue of his or her authority over investment decisions made with respect to the plan assets, or if the trustee is a directed trustee, by virtue of his or her authority or control to carry out the proper directions of the Plan Administrator or the named fiduciary, or the proper directions of the plan participants, with respect to plan investments. When the Plan Administrator or other fiduciary is tasked with the responsibility of determining the investment menu of a participant-directed plan, the exercise of that authority is a 3(21) fiduciary function because it will identify the scope of the investments that can be made with plan assets.

Under the management and administration portion of the 3(21) definition, a person must exercise or possess discretion in order for the 3(21) fiduciary status to be conveyed. Note for authority or control over plan assets, it only requires that control over plan assets be exercised regardless of whether the person had the authority to do so.

When a person or even a service provider has authority to determine what fees are to be paid by the plan, and whether the payment of such fees is permissible under ERISA, the exercise of that authority is a 3(21) fiduciary function because it constitutes authority or control over plan assets. Although a service provider might not perform fiduciary functions, if the contractual arrangement or the circumstances surrounding the service provider's relationship with the plan enable the service provider to set the fees payable to the service provider from the plan or to affect the level of such fees, there may be an issue as to whether the service provider has discretionary control over the management of the plan assets. If so, the service provider might be

[1] DOL Interpretive Bulletin 75-8, Q&A D-2.
[2] DOL Interpretive Bulletin 75-8, Q&A D-3.

a fiduciary as a result. This makes it very important for the service provider to disclose the fees that he or she receives with respect to the operation of the plan, including fees that are payable through investments held by the plan (e.g., 12b-1 fees on mutual fund investments). This disclosure enables the plan administrator or other responsible fiduciary to properly evaluate fees that are being paid to the service provider to determine whether those fees are reasonable. This is a requirement for fees payable to a service provider from plan assets to be exempt from the prohibited transaction (PT) rules.[3] The PT rules are covered in detail in Chapter 9.

A person may be a fiduciary because he or she actually exercises control of the plan's management or the disposition of plan assets, even if he or she does not actually have the authority to do so. By classifying such a person as a fiduciary because of such actions, the enforcement provisions of ERISA can be brought to bear against the person to recover any loss that the plan may have incurred because of such person's actions.[4]

EXAMPLE 8-1. 401(k) Contributions. An officer of a corporation is responsible for the allocation of corporate assets to pay corporate expenses and obligations. Due to cash flow problems, the officer fails to issue a check to the 401(k) plan for participant contributions withheld from paychecks. Instead, the available cash is used to pay net payroll obligations, tax withholding obligations and bills the officer considers a priority. The officer is exercising control over plan assets by failing to meet the company's deposit obligations with respect to participant contributions to the 401(k) plan.

EXAMPLE 8-2. Loans From Plan. An employee is responsible for disbursing funds for participant loans, as directed by the plan administrator. The employee has no interpretive authority over the plan's provisions. Loans are made solely under the specific parameters of the plan's loan policy. Such a function is normally ministerial and would not make the employee a fiduciary. On the employee's own initiative, however, the employee makes loans of plan assets to third parties. Although the employee is not authorized to do so, the employee exercises actual control over plan assets when the employee makes these third party loans, which renders the employee a fiduciary with respect to these transactions.

A financial institution that engages in transactions with a plan is not a trustee or fiduciary merely because of such investment transactions.[5]

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[3] ERISA §408(b)(2) and IRC §4975(d)(2).
[4] *LoPresti v. Terwilliger*, 126 F.3d 34 (2nd Cir. 1997).
[5] *Wood v. CNA Insurance Companies*, 837 F.2d 1402 (5th Cir. 1988) (savings and loan was not a fiduciary merely because plan assets were invested in certificates of deposit with that institution); *Useden v. Acker*, 947 F.2d 1563 (11th Cir. 1991) (bank was not a fiduciary merely because it lent money to a plan).

INVESTMENT ADVICE FOR A FEE

A person is a fiduciary if he or she renders investment advice for a fee or other compensation, direct or indirect, with respect to any assets of the plan, or has any authority or responsibility to render such advice even if not actually rendered. For Employee Retirement Income Security Act (ERISA) purposes, the investment of assets is only one aspect of fiduciary status.

The following key elements are for determining if someone who renders investment advice is a fiduciary:

1. There must be investment advice services.
2. There must be a plan related recipient.
3. There has to be a fiduciary relationship, determined either by a functional fiduciary analysis or a self-proclaimed fiduciary status.
4. The person must be receiving a fee or compensation, either direct or indirect.

A person may be a fiduciary because of his or her right to provide investment advice in relation to a portion of the plan's assets. For example, an investment manager (defined later in the chapter) may have control over investment decisions with respect to 25 percent of the fund. In such case, the person is only a fiduciary over that portion of the plan.[6] However, see the discussion of co-fiduciary liability below.

The compensation received by a person for investment advice may be direct or indirect. Commissions constitute such compensation, so that a separate fee apart from commissions does not necessarily have to be paid for the recipient of the commissions to be treated as providing investment advice for a fee.[7] However, a broker or dealer who merely executes securities transactions, such as the purchase or sale of individual securities or mutual fund shares, is not treated as a fiduciary of the plan under this definition, even if he or she receives a commission. Department of Labor (DOL) Reg. §2510.3-21(d) sets forth guidelines as to when the execution of securities transactions may cause a person to be a fiduciary. Generally, the broker/dealer must have discretionary investment authority to be a fiduciary and not just make the purchases and sales under instructions that specify the security to be purchased or sold, the acceptable price range, the quantity to purchase or sell and the time frame in which to purchase or sell.

An advisor who provides investment recommendations to a plan or its participants could act in a non-fiduciary capacity as long as the investment advice falls outside the "5-part" test set forth in the DOL regulation under 3-21(c).[8]

Under the DOL 5-part test, an advisor is a fiduciary if all of the following conditions are met:

- A person renders advice to the plan as to the value or advisability of buying, selling, investing in securities or other materials;

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[6] DOL Reg. §2510.3-21(c)(2).
[7] *Reich v. McManus*, 883 F.Supp. 1144 (N.D.Ill. 1995).
[8] Preamble to the Final Conflict of Interest Rule, pg. 9.

- On a regular basis;
- Pursuant to a mutual agreement, arrangement, or understanding, written or otherwise, between the plan or a plan fiduciary;
- That the services will serve as a primary basis for investment decisions; and
- The advice will be individualized to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition or diversification.

Investment Education

When investment education is provided to participants, an issue arises as to whether such education really constitutes the provision of investment advice. If investment advice is being provided, such as specific investment recommendations, the provider will become a fiduciary. Dissemination of investment education materials often occurs in a participant-directed defined contribution plan.

Fiduciary Status is Not an All or Nothing Concept

Fiduciary classification is not an all or nothing concept, meaning that a person may be a fiduciary with respect to one aspect of plan administration or management, or be a fiduciary with respect to only a portion of plan assets over which he or she renders investment advice for a fee. The DOL makes note of this principle in FR-16 of Interpretive Bulletin 75-8, where it states that a fiduciary, other than a named fiduciary, is a "fiduciary only to the extent that he or she performs one or more of the functions described in section 3(21)(A) of the Act. The personal liability of a fiduciary … is generally limited to the fiduciary functions which he or she performs with respect to the plan." Many court decisions have also recognized this view. Keep in mind, though, that a fiduciary can also incur liability through the **co-fiduciary liability** provisions under ERISA §405, where a person engages in activity described in ERISA §405 with respect to another fiduciary's breach.

A directed trustee is an example of limited fiduciary status. A directed trustee generally holds the plan's assets but follows the investment directions of another fiduciary (and has no discretion as to the investments). Although a fiduciary, a directed trustee has limited liability because he or she is unable to exercise discretion over the administration or management of the plan, or over the investment of assets.[9] (Directed trustees will be discussed in more detail later in the chapter.)

This limitation on the scope of the fiduciary's liability does not apply to the named fiduciary.[10] The named fiduciary is charged with the broadest fiduciary responsibility under the plan and can be liable for all phases of the plan's management and administration. This means the named fiduciary must take care to oversee the other fiduciaries of the plan. Failure to act prudently in this regard can subject the named fiduciary to liability for the breaches of the other fiduciaries.

[9] DOL's comments in Field Assistance Bulletin 2004-03 (December 17, 2004).
[10] DOL Interpretive Bulletin 75-8, Q&A FR-16.

ANALYSIS OF FIDUCIARY STATUS

Considering the above principles, let us analyze whether persons serving in certain positions would be classified as fiduciaries.

Trustee

A **trustee**, by virtue of his or her position, will be a plan fiduciary, but the scope of the trustee's duties may be limited, which will affect the trustee's liability under certain circumstances. Frequently, the owners or officers of the corporation, or other employees of the corporation, will be named as trustee. Other times, a committee made up of corporate employees (whose identity might change from time to time) will serve as trustee. Those who act on the corporation's behalf in carrying out its duties as trustee would also be fiduciaries of the plan.

Custodian

A **custodian** has possession of plan assets but generally lacks any discretionary authority with respect to the disposition of those assets or the administration or management of the plan.[11] A custodial relationship with the plan might result in fiduciary status, regardless of the nondiscretionary authority, simply because the custodian is in a position to control plan assets. However, the scope of the duties of the custodian is likely to significantly limit his or her fiduciary liability exposure.

Employer

The employer generally wears two hats in its relationship to the plan: one is as the entity that establishes and maintains the plan (referred to as the *settlor* of the trust), which does not create a fiduciary relationship. The other is as the **plan administrator** with authority over the plan's administration and management, which is a fiduciary function. There has been a great deal of litigation regarding the circumstances under which an employer's actions are fiduciary in nature and when they are settlor functions that are not fiduciary in nature.

When analyzing whether activities are fiduciary in nature, the DOL and the courts have distinguished between so-called **settlor functions** and **administrative functions**. *Settlor* is a term from trust law, which means the individual or entity that establishes a trust. In the case of an employee benefit plan, this is generally the plan sponsor.

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[11] *Arizona State Carpenters Pension Fund v. Citibank*, 125 F.3d 715 (9th Cir. 1997) (The bank was not an ERISA fiduciary merely because it served as custodian of the assets. In other words, custody of assets is not the same as control over those assets for fiduciary status purposes. The court looked to Citibank's duties under the custodial agreement, which specifically limited Citibank's responsibilities and authority. Citibank was not responsible for the adequacy of the employer's contributions, and had no duty to recommend, select or approve investments. The agreement did not purport to delegate any fiduciary duty to Citibank, nor did it provide Citibank with independent authority or managerial responsibility over the operation or administration of the trust funds.)

Settlor Function

When a plan is adopted, the employer is acting as the settlor of the trust that is created to fund the plan. Similarly, the act of amending or terminating the plan is an act of the settlor of the trust. Settlor functions are not fiduciary functions. However, activities relating to the ongoing administration and management of the plan are generally fiduciary functions. In general, actions taken by an employer with respect to the adoption of a plan or an amendment to the plan's terms are not treated as fiduciary in nature.

A settlor type of committee would be charged with functions such as:

- The employment of agents, legal counsel and other non-fiduciary persons;
- Preparing reporting forms and plan amendments;
- Paying Pension Benefit Guaranty Corporation (PBGC) premiums (if applicable); and
- Maintaining records not required to be maintained by fiduciaries.

Administrative Function

On the other hand, the functions necessary to implement and administer a retirement plan are administrative functions, and such functions must be carried out with the level of care required from a fiduciary. Examples of such functions are the allocation of contributions, the payment of benefits, the performance of nondiscrimination testing, and the determination of vesting.

Some employers, particularly larger companies, will separate out the responsibilities for settlor functions and fiduciary/administrative functions, typically through the creation of separate committees, with each committee consisting of more than one individual.

A fiduciary or administrative type of committee would be charged with functions such as:

- Allocation of fiduciary responsibilities (which may include appointment of persons outside of the committee);
- Control of the operation and administration of the plan;
- Evaluation of appointed persons and removal if necessary;
- Hiring of investment managers;
- Determination of investment menu if plan is participant-directed (or hiring of someone to do so);
- Development and maintenance of a funding policy and investment policy statement;
- Adoption and enforcement of procedural rules for the plan (e.g., QDRO procedures, loan procedures, direction of investment procedures);
- Determination of eligibility for the plan;
- Review of claims for benefits;
- Maintenance of records required by ERISA (e.g., records to support benefit determinations);
- Interpretation of the plan provisions; and
- Preparation and furnishing of required disclosure documents (e.g., SPD).

This approach accomplishes several objectives. First, it clearly charges the responsible persons with the duties they have with respect to the plan. Second, it minimizes the fiduciary exposure for those officers and employees who are serving in the settlor roles. Third, it clarifies the status of attorney-client communications. (Communications to a fiduciary who is acting in such capacity are generally not privileged.)

Some practitioners will name individuals or a committee to serve as plan administrator rather than designating the employer to serve in this role. It is unlikely that this avoids fiduciary status for the employer.

Amendment of Plan is Not a Fiduciary Action

There have been numerous cases dealing with an employer's actions in amending the plan. The courts have held that the amendment of the plan is not a fiduciary action. Instead, it is a settlor function for which ERISA liability will not arise.[12]

Adoption of plan is also not a fiduciary action. In *Akers v. Palmer*,[13] participants were unsuccessful in suing for actions taken with respect to the creation and initial funding of a corporation's employee stock ownership plan (ESOP). The court determined that the plaintiffs were challenging corporate behavior, not fiduciary actions. ERISA does not apply to company actions occurring prior to the creation of an employee benefit plan. The company's decision to establish an ESOP and to fund it with newly-issued stock was the act of a settlor and therefore immune from scrutiny under Title I.

Plan Termination is Not a Fiduciary Action

Like the creation or amendment of a plan, the decision to terminate the plan is not a fiduciary action, but a settlor function.[14] However, once the decision to terminate the plan is made, there are necessary actions that must be taken by the plan fiduciaries that are subject to ERISA's fiduciary standards. For a terminated defined benefit plan, these include the proper allocation of assets under ERISA §4044, calculating accrued benefits, notifying participants of their distribution rights, the determination of whether any surplus in the plan may be reverted to the employer, and selecting insurance carriers to pay annuity benefits.[15]

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[12] *Hughes Aircraft Company v. Jacobson*, 119 S.Ct. 755 (1999) (amendment of contributory defined benefit plan to add noncontributory benefit structure and use surplus funding to fund the increased liabilities was not a fiduciary action), *Lockheed Corp. v. Spink*, 517 U.S. 882 (1996) (amendment to eliminate maximum age exclusion from defined benefit plan without crediting pre-1988 service for benefit accrual purposes was not a fiduciary action), *Corcoran v. Bell Atlantic Corp*., 22 EBC 1489 (3rd Cir. July 30, 1998) (amendment of traditional defined benefit plan into a cash balance plan was not a fiduciary action- plaintiffs were challenging the actuarial assumptions being used to determine the opening cash balance accounts), *Gard v. Blankenburg,* 27 EBC 1776 (6th Cir. 2001) (adoption of amendments by trustees of multiemployer plan, which added joint and 100 percent survivor annuity option and a break in service benefit reinstatement provision, was not fiduciary action), and *Johnson v. Georgia-Pacific Corp*., 19 F.3d 1184 (7th Cir. 1994) (amendment to provide a benefit increase that applied only to active participants was not a fiduciary action, even if the persons responsible for making the amendment (e.g., the officers of the company) also serve as fiduciaries of the plan).
[13] 71 F.3d 226 (6th Cir. 1995).
[14] *Morse v. Adams*, 857 F.2d 339 (6th Cir. 1988) (decision to terminate welfare benefit plan was not fiduciary action).
[15] *Bussian v. RJR Nabisco, Inc*., 25 EBC 1120 (5th Cir. August 14, 2000) and DOL Interpretative Bulletin 95-1.

In a Supreme Court case, a union whose members were covered by a defined benefit plan attempted to classify the decision of a company to terminate its overfunded plan, rather than to merge it with the union plan, as a fiduciary decision. The argument made by the union was that the merger was a type of plan termination, and the choice between the two termination options was a fiduciary action. The Court rejected this argument, finding that a merger is not a type of plan termination, and finding further that the decision to terminate was a settlor function.[16]

Officers or Directors of a Corporate Employer

An officer of the employer is not a fiduciary merely by holding such a position. To be a fiduciary, the officer must have responsibility for one of the functions described in the fiduciary definition.[17] Similarly, the DOL has taken the position that the members of the board of directors are fiduciaries only if they have responsibility for one of the functions described in the fiduciary definition. An example of fiduciary responsibilities would be decision-making authority over the selection and retention of plan fiduciaries because that constitutes discretionary authority over the plan's management. In many cases, the employer is a fiduciary by virtue of its designation as plan administrator, and it must appoint individuals to carry out such functions. To the extent an officer or director is allocated responsibilities of the plan administrator and does not render only ministerial functions, he or she is a fiduciary of the plan.[18]

An individual officer who is taking on a fiduciary role with respect to a corporation's plan should make sure he or she is adequately insured. The corporation will often agree to carry such insurance for the individual. In addition, an indemnification agreement would help manage the fiduciary's economic risk. Indemnification might be offered in lieu of insurance or as a supplement to insurance (e.g., to cover liability not covered by the policy).

An employer may want to consider hiring an independent fiduciary who can help to minimize the personal liability exposure of the company's officers, particularly if company stock is held by the plan (whether by participant direction, fiduciary investment decision or plan design). Fiduciary liability is not an all or nothing proposition, and fiduciary responsibilities may be allocated among several individuals (although a fiduciary may not ignore a fiduciary breach by a different fiduciary merely because the breach is not part of his or her allocated responsibilities).

Employees of the Employer

Generally, an employee of the employer, unless the individual is an officer, will not have the requisite discretion or control, with respect to his or her responsibilities, to make the employee an ERISA fiduciary. However, the facts and circumstances of the employee's position may need to be analyzed to determine if fiduciary status arises. Note, too, that even if the employee is not acting as a fiduciary or as an agent of the employer, the employer could have liability exposure for actions taken by an employee. An element of the fiduciary standard of prudence is

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[16] *Beck v. PACE International Union*, 55 U.S. 961, 127 S.Ct. 2310, 40 EBC 2281 (S. Ct. 2007).
[17] DOL Interpretive Bulletin 75-8, Q&A D-5.
[18] DOL Interpretive Bulletin 75-8, Q&A D-4.

appropriate review and evaluation. In the context of the employer's fiduciary role as plan administrator, failure to make a prudent review and evaluation of, or to properly train, employees who are charged with carrying out the operation of the plan could lead to fiduciary liability against the employer.[19]

Attorneys, Accountants, Actuaries and Other Third-Party Providers

A third-party service provider, such as an attorney, an accountant, an actuary, a third-party administrator (TPA) or a consultant, is ordinarily not a fiduciary solely because of the performance of such professional services. However, if the factual situation in a particular case falls within one of the enumerated fiduciary functions, then the person will be considered a fiduciary under ERISA.[20]

Accountant

The accountant's function is generally one of preparation of forms, filings with the government and plan recordkeeping. These functions are usually ministerial in nature and do not cause the accountant to be a fiduciary.

In *Martin v. Feilen*,[21] an accountant's activities were held to be fiduciary in nature because the accountant regularly recommended investments, structured investment deals and provided other investment advice. The other fiduciaries were corporate officers who did not have the sophistication or expertise to devise the investment schemes the plan was involved in, pointing to effective control by the accountant over the management of plan assets.

Actuary

The actuary's normal responsibilities include calculation of the minimum funding requirements under a defined benefit plan, calculating optional forms of benefit under the plan, applying the limits under Internal Revenue Code (IRC) §415(b) to benefit payments, preparation of the Schedule SB or MB for the Form 5500 filing and preparation and filing of forms relating to plan termination with the PBGC. These are ministerial duties that do not involve discretionary authority over the plan's management or administration, so the actuary is generally not a fiduciary with respect to the plan.

In *Mertens v. Hewitt Associates*,[22] the Supreme Court ruled that an actuarial firm was not acting in a fiduciary capacity in rendering its actuarial services. Therefore, the actuary could not be found liable under ERISA for the funding shortfall that resulted from the actuary's failure to take into account significant increases in the plan's early retirement benefits in calculating funding liabilities.

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[19] *Schmidt v. Sheet Metal Workers' National Pension Fund*, 128 F.3d 541 (7th Cir. 997).
[20] DOL Interpretive Bulletin 75-5, Q&A D-1.
[21] 965 F.2d 660 (8th Cir. 1992).
[22] 113 S.Ct. 2063 (1993).

Attorney

An attorney's function is usually to provide legal advice regarding the operation of the plan. The rendering of legal advice is subject to the professional standards established by the American Bar Association. The courts have generally recognized that to overlay ERISA fiduciary standards on the attorney's rendering of professional advice could raise conflicting duties, and so have generally held that an attorney's services are nonfiduciary in nature.

Broker

Merely executing securities transactions does not make a broker a fiduciary. The particular facts and circumstances of the relationship between the broker and the plan must be analyzed to determine if a fiduciary relationship has been established. A broker may become a fiduciary in fact if he or she exercises discretion in the buying or selling of assets, or renders investment advice to a plan for a fee.

Insurance Agent

The fiduciary status of an insurance agent will depend on the facts surrounding the relationship between the agent and the plan administrator and/or trustees. If the insurance agent makes purchases and sales of insurance products solely at the direction of a fiduciary, the agent is generally not a fiduciary even though the insurance agent is compensated through commissions on those transactions. The issue usually comes down to whether the nature of the relationship indicates that the agent is rendering investment advice for a fee or has discretionary authority over the management or administration of the plan.[23]

Insurance company. An insurance company is generally not a fiduciary merely because plan assets are invested in contracts with the insurance company. That is because plan assets generally do not include the underlying assets of the insurance company with respect to a contract issued by the insurer to an employee benefit plan. This is known as the **guaranteed benefit policy exception** to the definition of plan assets.

Third-Party Administrator (TPA)/Plan Services Provider

A TPA (or other third-party service provider that performs administration services for plans) tends to be involved in a broader range of plan activities than many of the other service providers identified above. The facts and circumstances of the relationship are very important in assessing whether the TPA is performing only ministerial functions necessary to the plan's operation. The

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[23] Compare *Reich v. Lancaster*, 843 F.Supp. 1294 (N.D.Tex. 1993) (an insurance agent's relationship with the trustees, who were unsophisticated investors, was sufficient to vest the agent with discretionary authority over the plan investments, making the agent a fiduciary for ERISA purposes) to *Schloegel v. Boswell*, 994 F.2d 266 (5th Cir. 1993) (an insurance agent was not exercising control over the investment of plan assets when he sold the plan insurance that exceeded the incidental limits, because he merely made a presentation to the participants about the life insurance investments. The trustees made the final decision to invest in the contracts. For the insurance agent to be a fiduciary with respect to these investments, the plaintiffs had to show that the agent caused the trustees to relinquish independent discretion over the investment of plan assets in favor of the agent's recommendations).

TPA must take care not to cross the line into the realm of discretionary authority over plan administration or management.

If You're Curious . . .

An important case on TPA liability is *CSA 401(k) Plan v. Pension Professionals Inc.*[24] Pension Professionals Inc. (PPI) was hired by CSA to provide TPA services for its 401(k) plan, including the preparation of reports (e.g., Form 5500). Approximately six months into the relationship, PPI discovered discrepancies between the amount of funds that CSA withheld from employee paychecks for 401(k) contributions and the amounts actually deposited into the employees' retirement accounts in the plan. PPI formally notified the trustee that the failure to deposit the employees' contributions violated the law and could be classified as both embezzlement and a breach of fiduciary duties under ERISA. PPI also said that it would have to disclose the shortage on the financial reports that it was required to prepare. CSA agreed to a repayment schedule as outlined in a letter to PPI. After consulting with legal counsel, PPI agreed to continue to provide third-party administration duties for the plan as long as CSA adhered to the repayment schedule. PPI began including the following language on all participant statements: "Contrary to the requirements of the Department of Labor and the Internal Revenue Service, a portion of the 401(k) benefits have not yet been received by the trust." PPI also required verification of CSA's compliance with the repayment schedule (i.e., copies of deposited checks) and indicated that it would withdraw as the TPA if CSA failed to follow the repayment schedule. Later, CSA fell out of compliance with the repayment schedule and provided falsified financial statements to PPI. PPI resigned as the TPA. When it resigned, PPI did not inform law enforcement authorities. Four years later, the trustee pleaded guilty to embezzling the missing funds. This lawsuit was brought by former employees of CSA and participants in the plan against PPI, seeking to recover the embezzled funds. They claimed that PPI was liable as a fiduciary for the misappropriated funds because it exercised authority and control over plan administration after its discovery of the embezzlement, and failed to take reasonable steps to warn the participants or governmental authorities.

The court ruled that PPI was not a fiduciary under the facts of this case and, thus, could not be held liable as a fiduciary for the embezzlement. The court held that PPI's conditions to continue providing services to CSA were designed to assert control over its own engagement and not to exercise authority or control over the plan's management or administration. Authority over the acceptance of those conditions remained with the trustee of the CSA plan. In fact, PPI sent a letter to CSA which noted that PPI had "no authority, nor the ability, to make the needed changes to the CSA 401(k) Plan; that is your [CSA's] responsibility." The trustee of the CSA plan was free to accept or reject PPI's conditions. The trustee had the option of firing PPI and retaining another TPA. The court also noted that the trustee's subsequent embezzlement and furnishing of fraudulent reports to PPI indicated that control over the plan was always within the trustee's hands. Furthermore, the court expressed concern over finding fiduciary status arising from a service provider's efforts to make things right, citing *Beddall v. State Street Bank and*

[24] 23 EBC 2241 (9th Cir. 1999).

> *Trust Co.*, 137 F.3d 12 (1st Cir. 1998), where a court refused to find Good Samaritan liability under ERISA.
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> The plaintiffs in the CSA case also contended that PPI had a duty to report to the participants its suspicions regarding possible criminal breach of fiduciary duties by the trustee. The court rejected this argument because it presumes that PPI is a fiduciary. Only a fiduciary would have an ERISA obligation to report such wrongdoing. The court, however, noted that PPI insisted on the disclosure notice on the participants' statements, and "[a]s a nonfiduciary, PPI's duty to warn ended there."

Whether a TPA is a fiduciary is a functional test, according to a spokesperson for the DOL's Plan Benefit Security Division. If a TPA exercises discretionary control, it is probably a fiduciary. Furthermore, the nature of the relationship between a TPA and the trustees of the plan can determine whether the TPA functions as a fiduciary. In a case in which the trustees relied on the TPA's advice regarding the holding of investments, a court found that the TPA was a fiduciary.[25] The same issue can arise when an employer, in carrying out its discretionary duties as the plan administrator, relies on the TPA's advice to the point where discretionary authority to administer or manage the plan has shifted to the TPA.

Although a TPA is generally not performing fiduciary functions, the TPA is contractually obligated to perform the services it has agreed to. The TPA may be sued for negligence or breach of contract with respect to its obligations to the employer and/or plan. Since such a cause of action relates to the contractual obligation, and not to fiduciary duties, ERISA would not preempt such a claim.[26]

Representatives from the DOL have expressed the view that a service provider's failure to disclose to the plan fiduciary the soft dollar fees (i.e., fees through investments held by the plan, such as subtransfer agency fees, 12b-1 fees, etc.) received by the service provider could possibly cause the service provider to become a fiduciary, because the receipt of undisclosed fees could, under certain facts and circumstances, be construed as taking control over plan assets or plan management, as described in ERISA §3(21). As of July 16, 2011, certain service providers are subject to mandatory fee disclosure rules that would include disclosure of these investment-related fees received by the service provider. Failure to do so would result in a PT.

NAMED FIDUCIARY

ERISA §3(16)(A) provides a way to identify the plan's administrator. The plan document must name at least one fiduciary or provide a procedure for identifying a named fiduciary.[27] ERISA §3(16)(A) does not describe what a plan administrator is or what makes one a fiduciary. However, the named fiduciary, also called a 3(16) fiduciary, will be responsible for a number of

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[25] *Brock v. Self*, 632 F.Supp. 1509 (W.D.La. 1986).
[26] *Shofer v. Stuart Hack Co*., 22 EBC 2593 (Md. Ct. of Special Apps. 1999) (relating to a TPA's negligence regarding an employer's administration of its loan program, although in this case the TPA was not found liable for negligence).
[27] ERISA §402(a).

plan administrative duties that will be fiduciary in nature according to the definition of a fiduciary under ERISA §3(21). The purpose of the named fiduciary requirement is to enable employees and other interested persons to ascertain who is responsible for operating the plan.

The plan document does not have to expressly designate a person as the named fiduciary. If the document designates a person to be primarily responsible for the operation and administration of the plan, that person is the named fiduciary for ERISA purposes.[28] Most plans use the term plan administrator or administrator, and the person defined to serve in that capacity is a named fiduciary for purposes of ERISA §402(a). The named fiduciary may be more than one individual. For example, a retirement committee, administrative committee or advisory committee can serve as the named fiduciary. The named fiduciary may also be a corporation, but the DOL recommends that the plan document provide for designation of individuals by the corporation to carry out the specified fiduciary responsibilities.[29]

The named fiduciary may be given the authority to appoint a trustee or investment manager and to allocate responsibilities for plan administration to other fiduciaries.[30]

FIDUCIARY STATUS NOT CREATED BY GOOD SAMARITAN ACTIONS TAKEN BY SERVICE PROVIDER

Service providers often have a very close relationship with the plan administrator and may find themselves aware of fiduciary violations or potential violations. In some cases, a service provider might try to take steps to help correct these violations. When these steps fail to resolve the problem, participants sometimes seek recovery against the service provider on the basis that the service provider's involvement made it a fiduciary. The courts are wary of imposing liability on the service provider for losses arising from a fiduciary's violation merely because the steps taken by the service provider to help the fiduciary correct the violation ultimately proved to be futile in preventing losses to the plan participants.[31] The courts generally have refused to find Good Samaritan liability against a service provider that is trying to make things right. Critical to these findings, however, is that the service provider did not usurp the plan administrator's discretionary authority over the management or administration of the plan, but simply used its position as a service provider to try to help the plan's fiduciaries satisfy their ERISA duties.

INVESTMENT MANAGER

Investment manager, also called a 3(38) fiduciary, is an ERISA term that refers to a fiduciary (other than the trustee or named fiduciary) who has the power to manage, acquire or dispose of

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[28] Interpretive Bulletin 75-5, FR-1.
[29] Interpretive Bulletin, 75-5, FR-3.
[30] ERISA §§402(b)(2), 403(a) and 405(c).
[31] *Beddall v. State Street Bank and Trust Co*., 137 F.3d 12 (1st Cir. 1998) and *CSA 401(k) Plan v. Pension Professionals Inc*., 23 EBC 2241 (9th Cir. November 23, 1999).

any asset of the plan, and who has acknowledged in writing that he or she is a fiduciary.[32] ERISA §3(38)(B) permits only the following persons to act as an ERISA investment manager:

- A registered investment adviser (meaning that the person is registered under the Investment Advisers Act of 1940 or, where section 203A(a) prevents registration under the Investment Advisers Act, the person is registered by a State and files a copy of the state-registration form with the DOL);
- A bank; or
- An insurance company qualified to perform investment management services under state law.

Only a named fiduciary may appoint an investment manager.[33] ERISA §405(d) provides that if an investment manager is appointed, pursuant to ERISA §402(c)(3), the trustees are not liable for the acts or omissions of such investment manager, nor are they under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.

A 3(38) fiduciary is also a 3(21) fiduciary because the 3(38) fiduciary is given control to manage the plan's assets which are listed as a fiduciary function under ERISA §3(21).

ALLOCATING FIDUCIARY RESPONSIBILITIES

The plan may provide a procedure for allocating fiduciary responsibilities among the named fiduciaries. In addition, the named fiduciaries may designate other persons to carry out fiduciary responsibilities.[34] Trustee responsibility, meaning any responsibility to manage or control the assets of the plan, may not be allocated to other fiduciaries, except to the trustee or to a properly appointed investment manager.

If the plan has specific authority for the named fiduciaries to allocate their responsibilities among themselves or to others, then each named fiduciary will be liable for those responsibilities allocated to him or her, and is generally not liable for the responsibilities allocated to other named fiduciaries or for the acts and omissions of another fiduciary designated by the named fiduciary.[35] However, the named fiduciary has a duty to monitor and review the performance of the persons he or she designates to serve in a fiduciary capacity. The performance of trustees and other fiduciaries must be reviewed by the appointing fiduciary at reasonable intervals so as to reasonably ensure that their performance has been in compliance with the terms of the plan and statutory standards. Failure to fulfill this duty may result in liability with the appointing fiduciary.[36]

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[32] ERISA §3(38)(A) and (C).
[33] ERISA §402(c)(3).
[34] ERISA §405(c).
[35] ERISA §405(c)(2), Interpretive Bulletin 75-8, FR-13 and FR-14.
[36] DOL Interpretive Bulletin 75-8, Q&A FR-17.

SERVING IN DUAL CAPACITY

A person may serve in more than one fiduciary capacity, including service as both trustee and plan administrator.[37] For example, it is not a violation of the ERISA fiduciary standards, including the PT rules, if officers or owners of the plan sponsor serve as trustees of the plan.

COMPENSATION FOR FIDUCIARY SERVICES

A fiduciary may receive reasonable compensation for his or her services. A fiduciary who receives full-time pay from the employer may not receive compensation from the plan for performing his or her fiduciary duties, but may be reimbursed for out-of-pocket expenses.[38]

PERSONS PROHIBITED FROM HOLDING CERTAIN POSITIONS

A person convicted of any felony listed in ERISA §411 cannot hold any of the following positions in regard to a plan for a period of 13 years: administrator, fiduciary, trustee, custodian, counsel, agent, employee or representative of the plan. Felonies listed in ERISA §411 include robbery, bribery, extortion, embezzlement, fraud, grand larceny, burglary, arson, substance abuse, murder, rape, kidnapping, perjury, assault and criminal violations of ERISA or the Labor-Management Relations Act.

CAN A PARTICIPANT BE A FIDUCIARY?

ERISA §408(c)(1) contemplates that a fiduciary may also be a participant in the plan. Thus, a fiduciary-participant may receive benefits under the plan, so long as they are calculated in a manner that is consistent with the terms of the plan. Parallel rules appear in IRC §4975(d)(9), so that an excise tax does not apply to the receipt of such benefits under the PT rules.

Under ERISA §404(c), when a participant directs the investment of his or her benefits, that individual is responsible for any losses that are incurred by his or her own account due to his or her own investment decisions. Although this creates a self-fiduciary status with respect to the participant's account, the exercise of investment-direction rights does not make the participant a fiduciary of the plan for Title I purposes.[39] The Tax Court, however, has ruled that the participant is a fiduciary for PT purposes under IRC §4975.[40]

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[37] ERISA §402(c)(1).
[38] ERISA §408(c)(2) and IRC §4975(d)(10).
[39] ERISA §404(c)(1)(A).
[40] *Flahertys Arden Bowl, Inc. v. Commissioner*, 115 T.C. 269 (Tax Ct. 2000), *affirmed*, 2001 U.S. App. LEXIS 24557 (8th Cir. 2001).

8.03: Fiduciary Duties and Responsibilities

ERISA establishes a comprehensive list of fiduciary duties and responsibilities. These duties and responsibilities are designed to protect the benefits of the participants and their beneficiaries and to prescribe standards that may be enforced under Title I. The first step in this analysis is to identify the fiduciaries of the plan, which we have done in the prior section. The fiduciaries have a duty to protect the plan assets and to administer and manage the plan and trust in a manner that protects the interests of the plan participants and beneficiaries. This section discusses these fiduciary duties.

FIDUCIARY DUTIES RELATING TO GENERAL PLAN ADMINISTRATION AND OPERATION

Several of the ERISA fiduciary requirements relate to the plan's general administration.

Written Program Requirement

Every employee benefit plan must be established and maintained pursuant to a written instrument.[41] The documents under which the plan operates will establish the terms of the plan and 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.

Amendment Procedure

The plan must provide a procedure for amending the plan and for identifying the persons with authority to amend the plan.[42]

The Supreme Court was asked to interpret the amendment procedure requirement in *Curtiss-Wright Corp. v. Schoonejongen*.[43] The court concluded that ERISA §402(b)(3) requires two things:

A. A procedure for amending the plan; and
B. 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. ERISA §3(9) defines a person to include a corporation. The plan is not required to include additional language for identifying the person(s) with authority to act on behalf of the corporation (e.g., board of directors).

[41] ERISA §402(a)(1).
[42] ERISA §402(b)(3).
[43] 115 S.Ct. 1223 (1995).

Identification of Fiduciaries

The plan document must provide for one or more named fiduciaries who jointly or separately have the authority or control to manage the operation and administration of the plan.[44] The named fiduciaries will have the broadest responsibilities regarding the plan's operation. The plan document may provide for the allocation of fiduciary responsibilities among more than one named fiduciary, may permit the named fiduciary (or a designee of the named fiduciary) to employ persons to render advice with regard to the fiduciary's responsibilities and may authorize the named fiduciary to appoint an investment manager.[45]

Funding Policy Requirement and Investment Policy Statements

The plan must provide a procedure for establishing and carrying out a **funding policy** consistent with the objectives of the plan.[46] The purpose of this rule is to ensure that the fiduciaries charged with the responsibility for managing and investing plan assets do so in a manner that is consistent with the objectives and liquidity needs of the plan.

In Interpretive Bulletin 08-2, the DOL explains the use of investment policy statements, which may be designed to further the purposes of the plan and its funding policy. ERISA does not specifically require the development and maintenance of investment policy statements, but the maintenance of such statements is consistent with the fiduciary duty of prudence. A fiduciary developing an investment policy statement needs to consider the plan's funding policy and its liquidity needs, as well as, the issues of prudence, diversification and other fiduciary requirements.

An **investment policy statement** provides general instructions or guidelines applicable to investment situations, not specific instructions as to the purchase or sale of a particular investment. The policy may address issues such as the identification of acceptable classes or types of investments, or limitations on investment categories as a percentage of the plan's portfolio. The policy may also include general instructions on proxy voting decisions, such as the support of or opposition to recurring issues.

Bonding Requirements

Every fiduciary and every person who handles plan funds must be bonded.[47] This bond is called a **fidelity bond**.

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[44] ERISA §402(a)(1).
[45] ERISA §§402(b)(2), ERISA §402(c)(2), ERISA §402(c)(3).
[46] ERISA §402(b)(1).
[47] ERISA §412, DOL Reg. §§2580.412-1 through 2580.412-36.

Funds are handled by a person if that person's duties or activities pose a risk that the funds could be lost in the event of fraud or dishonesty. The person handling funds does not necessarily have to be a fiduciary. Handling is not an investment control concept, but rather one related to the receipt, safekeeping or disbursement of funds.[48]

A person who renders investment advice to a plan for a fee or other compensation, but who does not exercise or have the right to exercise discretionary authority with respect to the assets of the plan, is not handling funds and need not be bonded.[49]

Financial Institutions that Handle Funds

A fiduciary is exempted from the fidelity bond requirement if the fiduciary:

I. Is a U.S. corporation;
II. Is authorized to exercise trust powers or to conduct an insurance business;
III. Is subject to supervision or examination by federal or state authority; and
IV. Has combined capital and surplus in excess of $1,000,000.[50]

This exception also covers any director, officer or employee of such institution.[51]

If the fiduciary is a bank or other financial institution that is authorized to exercise trust powers and its deposits are not FDIC-insured, the fidelity bond exemption is not available, unless the bank or 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. Because the DOL has not made any determinations as to any acceptable state bonding or similar requirements, the exemption is not available to any institution with deposits which are not FDIC-insured.[52]

Amount of Bond

The amount of the bond must be fixed at the beginning of each plan year in an amount that is not less than 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 that cover different persons, or different classes or groups of persons, the amount must be determined based on the funds handled by all persons, classes or groups covered by that bond. A blanket bond may be purchased that covers all persons who handle funds.

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[48] DOL Reg. §2580.412-6.
[49] Interpretive Bulletin 75-5, Q&A FR-8.
[50] ERISA §412(a)(2).
[51] DOL Reg. §§2580.412-27 through 2580.412-30 for further guidance on the exemption for banking institutions. Further guidance on the exemption for insurance carriers is provided in DOL Reg. §§2580.412-31 through 2580.412-32. The authority of the Federal Reserve System over the subsidiary of a bank holding company constitutes regulation and examination by the Board of Governors of the Federal Reserve System within the meaning of these regulations. See DOL Advisory Opinion 2004-07A.
[52] DOL Advisory Opinion 2004-07A (July 1, 2004).

The maximum bond amount is increased to $1 million for a plan that holds employer securities. The 10 percent rule would still apply, so the amount of the bond would be the lesser of 10 percent of the amount of funds being handled, or $1,000,000.[53]

A small-plan filer under the Form 5500 reporting rules must satisfy certain conditions to be exempt from the requirement to obtain an annual audit of plan assets. One of the conditions requires the plan's bond to be no less than the value of non-qualifying plan assets (as defined by the regulation) if less than 95 percent of the plan's assets are qualifying plan assets. The amount limitations described above do not apply to the bonding requirements for the small-plan audit exemption.[54]

The DOL permits the bond to be purchased with plan assets because the bond protects the plan. In addition, it does not benefit any plan official, and does not relieve any plan official of any obligation to the plan.[55]

Requirements Regarding Scope and Form of the Bond

Following are scope and bond requirements:

- The bond must provide protection to the plan against loss by reason of acts of fraud or dishonesty.[56] Fraud or dishonesty is deemed to encompass all of the risks of loss that might arise through dishonest or fraudulent acts in handling funds.[57]
- 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.[58]
- 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 can be obtained at https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/ c570_a-z.htm#.

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 the insured 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 make certain 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 employee organization (union) is the first named joint insured with one or more plans, or if two or more

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[53] ERISA §412(a), as amended by §622 of the Pension Protection Act of 2006.
[54] DOL Reg. §2520.104-46(b)(1) and (d).
[55] DOL Interpretive Bulletin 75-5, FR-9.
[56] DOL Reg. §2580.412-7.
[57] DOL Reg. §2580.412-6.
[58] DOL Reg. §2580.412-9.

plans are named as joint insureds under a single bond with the first named acting for all insureds.[59] The bond must include a discovery period of no less than one year after the termination or cancellation of the bond.[60]

Requirements for Surety Company

The surety company that issues the bond must be a corporate surety incorporated under the laws of the U.S. or of any State.[61] 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 in the plan has significant control or financial interest (direct or indirect).[62]

Claims Procedure

A plan must have a claims procedure under which the participant or beneficiary may have an opportunity for review of any denial of a benefit claim.[63] The courts generally have held that a participant must first exhaust the administrative remedies under the plan's claims procedure before he or she may bring a suit for recovery of benefits. The plan's claims procedure must be described in the SPD.[64]

Recordkeeping Requirements under ERISA

Every person who is subject to file any report or to certify any information under Title I must maintain records for a period of no fewer than six years. The records must provide, in sufficient detail, the necessary basic information and data from which the required documents may be verified, explained or clarified, and checked for accuracy and completeness. The records must be available for examination by the DOL.[65] Furthermore, an employer is required to maintain records with respect to each of its employees sufficient to determine benefits due or benefits which may become due to those employees.[66] A civil penalty of $28 is imposed for each employee with respect to whom the requirement is not satisfied, unless it is shown that such failure is due to reasonable cause.[67] The civil penalty is subject to inflation adjustments.

QDRO Procedures

Each plan must establish procedures for determining whether a domestic relations order is a qualified domestic relations order (QDRO). The procedures should address administrative issues that might affect a participant's account pending the review of the order. The procedures should

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[59] DOL Reg. §2580.412-18.
[60] DOL Reg. §2580.412-19.
[61] DOL Reg. §2580.412-21 for more details on the requirements for the surety company.
[62] DOL Reg. §2580.412-22.
[63] ERISA §503.
[64] DOL Reg. §2520.102-3(s).
[65] ERISA §107.
[66] ERISA §209.
[67] ERISA §209(b); DOL Reg. 2570.209b-1.

also address the administration of distributions made pursuant to QDROs.[68] These procedures must be set out in writing. The DOL has provided some guidance regarding QDRO procedures at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/faqs/qdro-overview.

STANDARDS FOR FIDUCIARY CONDUCT

A fiduciary must carry out his or her duties solely in the interest of plan participants and beneficiaries.[69] How these standards are met will depend on the activities for which the fiduciary is responsible. The standards are:

- The **exclusive purpose rule**, which requires the fiduciary to carry out his or her duties solely for the purpose of providing benefits to participants and their beneficiaries, except to the extent that assets are expended for reasonable expenses relating to the plan's operation and administration;
- The **prudence standard**, which requires the fiduciary to discharge his or her duties in the manner of a prudent person with the care, skill, prudence and diligence of a person acting in a like capacity and familiar with such matters;
- The **diversification standard**, which requires that investments must be diversified so as to minimize the risk of large losses unless, under the circumstances, it is clearly prudent not to do so; and
- **Compliance with the plan documents**. Because ERISA requires that a plan be a definite, written program, the fiduciaries are required to follow the governing documents of the plan, except to the extent the documents are contrary to ERISA.

The indicia of ownership of plan assets must be maintained within the jurisdiction of the U.S. district courts.[70] This is to ensure that proper remedies are available to participants and beneficiaries for losses incurred due to fiduciary breach, i.e., the court cannot direct and enforce the treatment of assets that are outside its jurisdiction.[71]

Which plans are subject to ERISA's fiduciary standards? As a general rule, all employee benefit plans are subject to these ERISA's fiduciary standards, unless a statutory or regulatory exception exists.[72] Plans subject to these standards include welfare benefit plans, as well as pension benefit plans. The following plans are not subject to these rules:

- A **top hat plan** is exempt from the fiduciary standards because a top hat plan must be unfunded, meaning that a trust is not established for the exclusive benefit of the plan participants. Even where funds are set aside to back up the promise of benefits under a top hat plan, the funds must be held in a rabbi trust, which remains subject to the employer's general creditors. Furthermore, top hat plans may cover only a "select group of management or highly compensated employees."[73] Top hat plans are still employee

[68] ERISA §206(d)(3)(G).
[69] ERISA §404(a).
[70] ERISA §404(b).
[71] DOL Reg. §2550.404b-1.
[72] ERISA §401(a).
[73] ERISA §401(a)(1).

benefit plans for which the enforcement provisions of Title I of ERISA might be triggered to enforce the provisions of the plan.

- **Governmental plans and nonelecting church plans**, as described in ERISA §4(b)(1) and (2), are completely exempt from Title I of ERISA, which would include an exemption from the fiduciary standards.
- An **excess benefit plan**, as defined in ERISA §3(36), is completely exempt from Title I of ERISA, which would include an exemption from the fiduciary standards.

Exclusive Purpose Rule

The fiduciary's duties must be carried out for the exclusive purpose of:

- Providing benefits to participants and beneficiaries; and
- Defraying reasonable expenses of administering the plan.[74]

This rule correlates to the exclusive benefit rule for qualified plans.[75] The exclusive benefit rule affects the types of expenses that can be paid from plan assets.

Plan assets can be used to pay reasonable expenses, even if the plan document does not specifically authorize such payments, unless the document expressly obligates the employer to pay such expenses.[76] In other words, specific language in the document to authorize the use of plan assets to pay reasonable administrative expenses is not a precondition to paying such expenses. However, if the plan document obligates the employer to pay an expense, then the payment of such expense with plan assets would be a fiduciary violation because of the ERISA requirement for a fiduciary to follow the document's terms. It can also be a breach because the fiduciary has permitted the plan to pay for something which was actually an obligation of the plan sponsor.

The evaluation of fees is a prudence issue. Although most prudence issues are addressed below, we have included it under the discussion of the exclusive purpose rule because the use of plan assets to pay unreasonable or unnecessary fees is in violation of the requirement to use plan assets for the exclusive purpose of providing benefits under the plan. When making its evaluation, the fiduciary should consider the fees and service provider options in the marketplace, and the expertise and value provided by a particular service provider. The appropriate evaluation of fees is also a necessary element in the prudent selection and retention of service providers.[77]

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[74] ERISA §404(a)(1)(A).
[75] IRC §401(a)(2).
[76] CCH Pension Plan Guide, ¶19,986B.
[77] Advisory Opinion 2002-08A; see also, Final DOL Reg. §2550.408b-2(c).

Plan Administration Fees that Might Be Incurred by a Plan

Administrative fees are those incurred in the day-to-day operation of the plan to obtain basic administrative services (e.g., recordkeeping, accounting, legal or trustee services). Defined contribution plans also might include additional services relating to participant investments and withdrawals, including telephone voice response systems, access to customer service representatives, educational seminars, retirement planning software, investment advice, daily valuation, on-line transactions and a plan website to access account information.

Allocating Fees

A defined contribution plan must use an appropriate method for allocating administrative fees that are paid with plan assets and are billed separately. Some fees relating to plan administration might be paid by the issuer of an investment through the expense ratio charged against the income of the investment. In that case, the fees will automatically be allocated among the participants whose accounts contain the investment. Expenses that are the responsibility solely of the plan sponsor are generally referred to as **settlor fees**, which may not be paid with plan assets.

Investment Fees Applicable to Plans

Because the primary purpose of a funded plan is to provide benefits through the assets of the plan, the investment of those assets is of paramount concern, and a significant percentage of the fees incurred by the plan will relate to the investment of the assets. If fees are paid for investment management services, those fees typically are based on a percentage of assets. The plan's negotiating leverage, with respect to the percentage charged, will be affected by the dollar amount of assets being invested and the contribution activity of the plan. Fees relating to plan investment usually have an indirect effect on the participants because they are typically paid directly from the investment and simply go to the bottom line return of the plan's investments. Sales charges (a.k.a. loads or commissions) are transaction costs incurred when a plan buys or sells investments, whereas management fees (a.k.a. account maintenance fees or investment advisory fees) are ongoing charges for asset management and might include some administrative expenses.

Individual Service Fees Incurred by Participants

The plan might have optional fees for which charges are incurred, usually against only those participants who take advantage of these services. Fees associated with participant loans and participant direction of investments are typical examples of these individual service fees.

Prudence Standard

A fiduciary must discharge his or her duties in the manner of a prudent person with the care, skill, prudence and diligence of a person acting in a like capacity and familiar with such matters.[78] A fiduciary responsible for making investment decisions is subject to a prudence

[78] ERISA §404(a)(1)(B).

standard that would apply to a person familiar with investment decisions.[79] A plan administrator that is charged with the general operation and management of the plan is held to the standard of a person who is familiar with such responsibilities.

If You're Curious . . .

Should the Prudence Standard Apply Differently to Investments Made Under DC and DB Plans?

Because the employer is obligated to guarantee the benefits promised under a defined benefit (DB) plan, does the same standard of prudence apply with respect to investment decisions relating to a DB plan that applies to investment decisions under a defined contribution (DC) plan?

ERISA makes no direct distinction between the two types of plans. Certainly, a breach of fiduciary duty with respect to DC plan investments has a direct impact on the participants' level of benefits, because the loss reduces the value of account balances and the participants' benefits are determined by the value of those account balances. But imprudent investment decisions under a DB plan might have a number of adverse consequences that may put the participants' benefits in jeopardy. The level of plan assets may be significantly reduced, perhaps causing the plan to be unable to meet current benefit payment obligations. The resulting loss might also cause the employer's funding requirements to increase to a level that the employer is unable to meet, jeopardizing the plan's funding status and, in extreme cases, possibly leading to the employer's inability to meet financial obligations and having to declare bankruptcy. A subsequent termination of the plan may result in unfunded benefit liabilities and, even if the PBGC were to trustee the plan in a distress termination, the guaranteed benefit limits under Title IV of ERISA may result in some benefit liabilities remaining unsatisfied. Thus, as a general rule, fiduciaries should approach investment decisions regarding a DB plan with the same level of prudence they would in making similar decisions for a DC plan.

That said, however, there may be some mitigating factors. First, the determination of what constitutes prudent investment decisions will be affected by the funding policy that governs the plan. Also, the funding status of the plan may be a factor.

Conduct Relating to Investment Transactions

If the fiduciary is responsible for making investment decisions with respect to the plan, there is an obligation to be informed about investments made on behalf of the plan and to make a prudent evaluation of the performance of those investments. If the investment decision is made by a third party (e.g., a trustee, investment manager or investment advisor), there is an obligation on the part of the fiduciary responsible for hiring and firing that person to use prudence in selecting him or her and to review his or her performance (e.g., reviewing reports, comparing appropriate performance benchmarks) with a reasonable frequency. If the participants and beneficiaries are making investment decisions, there is more limited fiduciary liability, but the fiduciary responsible for choosing the investment menu available under the plan must exercise such responsibility

[79] DOL Reg. §2550.404a-1(b).

in a prudent manner and make periodic evaluations of the performance of the investment options offered by the plan.

Analysis is on the Fiduciary's Conduct at the Time Investment Decisions are Made

The courts must objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making the investment decision. The test of prudence is one of fiduciary conduct, not of the performance results of the investment (i.e., the plaintiff may not use 20/20 hindsight).

We normally think of fiduciaries with investment responsibility when we think of prudence. However, a standard of prudence governs all aspects of plan administration and management. Below, we address the following aspects of the prudence rule:

- Duty to investigate and review appointed fiduciaries and service providers;
- Reliance on third-party information;
- Collecting money owed to the plan;
- Duty to disclose information to participants and beneficiaries, with particular emphasis on the timing of disclosure (and the scope of disclosure) relating to benefit enhancements under consideration by the company;
- Administration of the plan's loan program;
- Valuation of hard-to-value assets;
- Response to extraordinary circumstances;
- Implementing automatic rollover provisions; and
- Conducting reasonable searches and paying out benefits of missing participants under terminated plans.

Duty to Investigate and Review

When hiring a person to perform fiduciary and/or service provider functions, the fiduciary is responsible for making a prudent evaluation of both the person and the reasonableness of the fees being charged for the service to be performed.

A fiduciary is also responsible for prudently monitoring the activities and reviewing the performance of persons he or she names to carry out specific duties relating to the plan's operation.[80] When a fiduciary is considering an investment and obtains expert advice (e.g., an appraisal, valuation or investment advice) to assist him or her in making a decision, the fiduciary must exercise prudence in choosing that person and relying on that advice.

Selection of service providers. The DOL believes that a responsible plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of a service provider, the quality of services offered and the reasonableness of fees charged in light of

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[80] Interpretive Bulletin 75-8, Q&A FR-17.

the services provided. This process should be designed to avoid self-dealing, conflicts of interest or other improper influence. Soliciting bids among service providers is recommended.[81] A prudent selection process is important regardless of whether the service provider will be carrying out fiduciary functions or purely administrative functions. When considering prospective service providers, give each of them complete and identical information about the plan and what services are needed so that a meaningful comparison can be made.

According to the DOL, some of the items that a fiduciary needs to consider when selecting a service provider include:[82]

- Information about the firm itself: financial condition and experience with retirement plans of similar size and complexity;
- Information about the quality of the firm's services: the identity, experience and qualifications of professionals who will be handling the plan's account; any recent litigation or enforcement action that has been taken against the firm; and the firm's experience or performance record;
- A description of business practices: how plan assets will be invested if the firm will manage plan investments or how participant investment directions will be handled; the proposed fee structure; and whether the firm has fiduciary liability insurance.

Some service providers may receive additional fees from investment vehicles, such as mutual funds, that may be offered under an employer's plan. For example, mutual funds often charge fees to pay brokers and other salespersons for promoting the fund and providing other services. There also may be sales and other related charges for investments offered by a service provider. Fiduciaries should ask prospective providers for a detailed explanation of all fees associated with their investment options.

Fiduciaries should document the selection (and monitoring) process. In addition, when using an internal administrative committee, the fiduciaries should educate committee members on their roles and responsibilities.

Monitoring the service provider. Although a fiduciary might conduct a prudent search for a service provider, the fiduciary's responsibilities to the plan do not end there with respect to that provider. Prudent monitoring and evaluation of the service provider is also required. This is in the fiduciary's best interest, too, because of potential co-fiduciary liability. Reviews should be conducted at reasonable intervals to decide if the fiduciary wants to continue using the current service providers or look for replacements.

Evaluation of fees paid by plan. The fiduciary who is responsible for the discretionary administration or management of the plan must periodically review the fees being paid by the plan for administrative services or investment services. This burden usually falls on the plan administrator, which is the employer in most cases. To assist fiduciaries in carrying their duty to

[81] DOL Advisory Opinion 2002-08A.
[82] DOL Publication "Meeting Your Fiduciary Responsibilities".

evaluate fees paid by the plan, the DOL issued rules, effective July 16, 2011, that require certain fee disclosures to be made by service providers as a condition of obtaining relief from the PT rules for the compensation received by such service providers with respect to the services being rendered to the plan.

Fiduciary May Rely on Third-Party Information

Interpretive Bulletin 75-8, FR-11[83] states:

> A plan fiduciary may rely on information, data, statistics or analyses furnished by persons performing ministerial functions for the plan, provided that he (or she) has exercised prudence in the selection and retention of such persons. The plan fiduciary will be deemed to have acted prudently in such selection and retention if, in the exercise of ordinary care in such situation, he (or she) has no reason to doubt the competence, integrity or responsibility of such persons.

In informal guidance, the DOL has published its views on the responsibilities of directed trustees under ERISA, particularly with respect to directions involving employer securities.[84] The DOL recognizes that, in determining whether the directions it receives are proper within the meaning of ERISA §403(a), the directed trustee may rely on information provided by the directing fiduciary.

Collecting Money Owed to the Plan

If there is money owed to the plan, the responsible fiduciaries must take reasonable, prudent steps to secure collection of such amounts. Sometimes a plan will pay a participant or beneficiary more benefits than are actually due from the plan. This may occur because of a computational error in the allocation of employer contributions, a miscalculation of vesting rights, or an error in valuing the plan’s assets used to calculate the amount of the distribution. One aspect of the exclusive purpose rule is that assets may not be used to overpay benefits. When a participant is overpaid, the payment of benefits to the remaining participants may be compromised and the responsible fiduciary has an obligation to restore those funds. In Advisory Opinion 77-32A, the DOL states that the prudence standard requires a fiduciary to “attempt, with the care, skill, prudence and diligence under the circumstances then prevailing…to collect money owed to the plan, including recovery of erroneous payments made from the plan.” To carry out this responsibility, the fiduciary might first make a demand to the participant for return of the overpayment. If the participant is due additional benefits from the plan, the overpayment may be applied against future payments if other reasonable attempts to collect the erroneous payment have failed.

In Field Assistance Bulletin (FAB) 2008-01, the DOL takes on the issue of who is responsible for collection of delinquent contributions owed to the plan. The FAB was prompted by the DOL’s discovery, in conducting pension plan investigations, of agreements that purport to

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[83] DOL Reg. §2509.75-8.
[84] DOL Field Assistance Bulletin (FAB) 2004-03 (December 17, 2004).

relieve the financial institutions serving as trustees of any responsibility to monitor and collect delinquent contributions. In many of these circumstances, there is no other trust agreement or plan document that assigns those obligations to another trustee or that imposes the obligations on a named fiduciary with the authority to direct a trustee. In other cases, the plan documents and trust agreements are ambiguous or don't mention the matter. Although employer contributions are not plan assets until contributed,[85] the employer's contributions are delinquent when they are due and owing to the plan under the documents governing such plan but have not been transmitted to the plan in a timely manner (e.g., delinquency in making a matching contribution required under a 401(k) plan, a minimum funding contribution under a pension plan, or a top heavy minimum contribution). When an employer fails to make a required contribution to a plan, the plan has a claim against the employer for the contribution, and the claim is an asset of the plan.

Duty to Disclose Information to Participants and Beneficiaries

Title I of ERISA imposes a number of mandatory disclosure requirements (e.g., the SPD requirement in ERISA §104(b)), for which the plan administrator (or other named fiduciary) is responsible. Fiduciary issues also arise, however, with respect to information that is not specifically required to be disclosed under Title I but which may affect a participant's benefit rights or a participant's decision with respect to the payment of benefits or the exercise of certain plan rights. In *Varity Corp. v. Howe*,[86] the Supreme Court held that an employer was acting in a fiduciary capacity when it made misrepresentations to employees about the future of their plan benefits because such actions were acts of plan administration. The courts have wrestled with the issue of whether a fiduciary has a duty to disclose certain information to participants as well as how ERISA's fiduciary standards come into play when a fiduciary chooses to disclose certain information.

Corporate decisions that might affect the plan. Corporate decisions that might affect the plan are generally not fiduciary actions and, therefore, do not raise any fiduciary duty to make disclosure.

Duty to disclose future benefit enhancements. If a company is planning to amend its benefit programs in a way that could benefit employees who postpone retirement, the courts are split on the scope of the fiduciary's disclosure duties to the potentially affected individuals. Most courts have held that, although the fiduciary does not have an obligation to disclose future benefit enhancements before they are adopted, the fiduciary must not misrepresent or mislead the participant if the fiduciary chooses to make disclosures or if the participant inquires about the future benefit enhancements. Other courts have held that there are more affirmative duties regarding disclosure.

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[85] Advisory Opinion 93-14A

[86] 116 S.Ct. 1065 (1996).

Duty to inform participants about circumstances that could jeopardize benefits. In *Barker v. American Mobil Power Corp.*,[87] a court held that a fiduciary had an affirmative duty to inform beneficiaries of circumstances that threaten the funding of benefits. A fiduciary is obligated to convey complete and accurate information that is material to the beneficiary's circumstance. Not only did the fiduciary in the Barker case fail to convey his suspicions about misappropriation of funds, but he misled the participants by reassuring them in writing that the investments were earning a fair rate of return and would be available for retirement. A fiduciary can be liable for losses incurred by participants due to the fiduciary's affirmative misrepresentations.

Information about distribution options. Prudence issues relating to disclosures can also arise in communicating with a participant or beneficiary about distribution options under the plan. ERISA §205 incorporates the qualified joint and survivor annuity rules, and ERISA §203 incorporates the minimum vesting standards, which include the requirement to obtain participant consent to distributions made before normal retirement age if the participant's vested benefit exceeds $5,000. Thus, the fiduciaries are obligated to carry out the notice and consent functions surrounding the implementation of these distribution provisions. Failure to make prudent disclosures may result in liability where the interests of the plan participant or beneficiary are harmed by the imprudent conduct.

Deficiencies in or failure to provide SPD may result in breach of prudence. An issue raised in some cases is the adequacy of the SPD. It underscores the importance of careful preparation of the SPD. Deficiencies in the SPD alone might not be sufficient to determine whether the fiduciary standard of prudence has been breached with respect to disclosures made to participants. The SPD will be considered in the total context of all surrounding circumstances to determine whether inadequate information has caused a loss to the participant or beneficiary.

Keeping track of addresses to satisfy disclosure obligations. If there are disclosure obligations with respect to a participant (particularly one who is a former employee) or a beneficiary, it is important for the plan administrator to maintain current records of addresses. However, there is shared responsibility here. When a former employee or beneficiary moves, the individual should promptly notify the plan administrator of the change of address. Plans with websites or other electronic or telephonic systems for updating personal information are more likely to have current address information. Good plan practice dictates giving periodic reminders to participants and beneficiaries of their obligation to notify the plan administrator of changes in address.

Disclosure relating to participant-directed investments. If plan investments are participant-directed, there are fiduciary duties based on ERISA §404(a) surrounding investment disclosures, fee disclosures and information regarding the investment choices. These disclosures include an annual chart, reflecting the specifics of the various investment options (including such items as the historic returns, the fees charged by the fund, and a benchmark comparison to a similar fund), as well as a quarterly disclosure of actual fees charged to a participant's account.[88] Although

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[87] 64 F.3d 1397 (9th Cir. 1995).
[88] DOL Reg. §2550.404a-5.

fiduciary liability can be significantly limited by complying with the requirements of ERISA §404(c), there are still potential liability issues to consider.

Prudent Administration of Participant Loan Program

The plan administrator or other fiduciary responsible for administering the plan's loan program must carry out those responsibilities in a prudent manner.

Valuation Issues

Prudence issues can arise with respect to the valuation of assets under the plan or the frequency with which assets are valued. This is true particularly in a defined contribution plan, where the value of the account balance affects the amount distributed to a participant.

Changing valuation dates or declaring a special valuation date to reflect significant change in asset values since last valuation date. 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. The employer may also want to think about modifying the valuation date provisions of the plan to call for more frequent valuations (e.g., amending a plan with a once-per-year valuation date to quarterly valuation dates). Of course, this may add administrative costs, but the extent of those costs will depend on the types of investments in the trust.

Valuation of hard-to-value assets. Investments in hard-to-value assets (e.g., limited partnerships, certain real estate or other property investments) raise important fiduciary concerns. Prudence from an investment standpoint is an obvious consideration. However, the prudence standard also extends to the administration of the plan. In this regard, the plan administrator is responsible for obtaining a reasonable valuation of the asset. The valuation can affect the amount distributed to a terminated or retired participant, administration of the plan's loan program (i.e., the value of a participant's account needed to determine loan limits, adequate security issues) and consent requirements (i.e., whether the participant's vested benefit exceeds $5,000). For Form 5500 purposes, the value of plan assets must be reported on an annual basis. Whether a full appraisal needs to be conducted on an annual basis will depend on the circumstances. If a hard-to-value asset is held as a directed investment by a single participant, there may be circumstances where the need for a more recent appraisal may not be necessary, even though under similar circumstances, an appraisal would be needed if the asset were held for the benefit of more than one participant (i.e., as a general trust investment for all participants, or part of a pooled investment fund into which more than one participant has directed the investment of his or her account). For example, the plan would not need to know the value of an asset held in the directed account of a single participant to make distributions to other participants in the plan.

Valuation of employer securities. The fiduciary's conduct in valuing employer securities also raises issues under ERISA's fiduciary duties, both at the time of acquisition of the securities by the plan, when purchase price is being determined, as well as ongoing administration of the plan (e.g., the effect of changes in the value of employer securities on the value of participant account balances, the determination of the amount to distribute to a participant whose account balance includes employer securities, etc.).

Extraordinary Circumstances May Require Modification of Investment Procedures

Sometimes fiduciaries will have to respond to extraordinary circumstances that may affect the management of the plan for a temporary period. One example would be the terrorist attacks on the United States on September 11, 2001. In News Release 01-36, the DOL recognized that fiduciaries might encounter an array of problems with respect to the investment of employee benefit plan assets upon the reopening of the securities markets following the attack. The DOL noted that such fiduciaries may in good faith find it necessary and prudent to take extraordinary steps to safeguard plan assets and to facilitate the return to orderly markets. It cautioned fiduciaries to be careful that temporary procedures so adopted and decisions so made be documented and be adequate to protect the interests of the plan participants and beneficiaries.

Implementing Automatic Rollover Provisions

IRC §401(a)(31)(B) requires that, in the absence of an affirmative election by the participant to receive a distribution, involuntary cash-out distributions in amounts exceeding $1,000 must be rolled over to an IRA.[89] The regulations provide a safe harbor method for a fiduciary to satisfy its ERISA obligations with respect to the selection of the IRA rollover vehicle and the initial investment of the rollover contribution. The safe-harbor standards are not intended to represent the exclusive means by which a fiduciary might fulfill the duties under ERISA with respect to automatic rollovers. As a practical matter, however, fiduciaries will probably implement automatic rollovers in a manner consistent with the safe harbor.

A plan might contain a more expansive default rollover procedure than what is required by IRC §401(a)(31)(B). However, the fiduciary relief provisions described above apply only to automatic rollovers implemented pursuant to IRC §401(a)(31)(B). The fiduciary responsible for implementing any other default rollover procedures (usually the employer, acting in its capacity as the plan administrator) will need to exercise prudence in carrying out his or her duties. The IRS noted in Notice 2000-36, which discussed default rollover procedures in a plan, that the DOL would treat the plan administrator's decision with respect to the choice of the IRA trustee, custodian or issuer as a fiduciary action.

When the plan fiduciary's responsibility ends with respect to a participant's benefit that has been transferred to the IRA. Normally, when a plan makes an automatic rollover to an IRA, the fiduciary remains responsible until the earlier of: (1) the date the participant takes control over the IRA, or (2) one year after the benefit is transferred to the IRA.[90] For this purpose, the

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[89] DOL Reg. §2550.404a-2, 69 F.R. 58018 (September 29, 2004).
[90] ERISA §404(c)(3)(A).

participant is deemed to take control over the IRA if he or she makes investment decisions with respect to the IRA, or elects to transfer the funds to another IRA. However, if the DOL's fiduciary safe harbor under DOL Reg. §2550.404a-2 is satisfied, the fiduciary's obligations with respect to the participant's benefit end immediately upon the transfer of the benefit to the IRA in accordance with the safe harbor rules. To qualify, the fiduciary safe harbor must be met with respect to an involuntary cash-out distribution of no more than $5,000 (or a greater amount, if the excess above $5,000 is attributable solely to rollover contributions and the plan has adopted the rule in IRC §411(a)(11)(D)).

Missing Participants Under Terminated Plans

Although the decision to terminate a plan is a settlor function, the steps to implement the decision to terminate, including steps to locate missing participants, are governed by ERISA's fiduciary standards. The choice of a distribution option with respect to a missing participant's account is a fiduciary decision. Therefore, the fiduciary has a duty to take reasonable steps to locate the participant, keeping in mind that fees and expenses incurred in the administration of the plan must be reasonable and necessary, and the manner in which the distribution is completed must be prudent and not contrary to the governing plan documents (except to the extent such documents would violate ERISA). The DOL provides informal guidance on this subject in the context of terminated defined contribution plans in Field Assistance Bulletin (FAB) 2014-01. The PBGC established a program under which the account balances of missing participants could be forwarded to the agency if certain conditions are met.

Diversification

Investments must be diversified so as to minimize the risk of large losses, unless, under the circumstances, it is clearly prudent not to do so.[91] This fiduciary standard applies only to a fiduciary responsible for investment or management of plan assets. Whether a fiduciary breaches his or her duty regarding diversification of investments must be assessed in the context of the fiduciary's investment responsibility. For example, a fiduciary responsible for managing the assets in a stock fund is analyzed for diversification on the basis of the stocks purchased by the fiduciary.

EXCEPTION FROM DIVERSIFICATION REQUIREMENT FOR CERTAIN INVESTMENTS IN EMPLOYER SECURITIES

Under ERISA §404(a)(2), an eligible individual account plan as defined in ERISA §407(d)(3) (such as an ESOP, a stock bonus plan, or a profit-sharing plan authorized to invest in employer securities) does not violate the diversification requirement solely because of the acquisition or holding of qualifying employer securities or qualifying employer real property. This exception enables those plans to invest up to 100 percent of plan assets in employer securities.

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[91] ERISA §404(a)(1)(C).

Investment must be prudent. The fiduciary is still subject to the prudence standard with respect to investments in qualifying employer securities or qualifying employer real property, except to the extent the prudence standard requires diversification.

Special Problems for ESOPs

Court decisions have tried to balance the issue of prudence with the stated purpose of an ESOP to invest primarily in employer securities. The Third and Sixth Circuits have adopted an abuse of discretion standard in reviewing the fiduciary's actions.[92] According to these cases, there is an implied authority to divest the plan of its investments in employer securities if it is prudent to do so, even though the plan document might require that investments be primarily (or exclusively) in employer securities. The requirement to follow the governing plan document is overridden if following the document would be inconsistent with ERISA's fiduciary standards. The fiduciary has less discretion to act when he or she is also a director or officer of the corporation and may have divided loyalties. If the fiduciary cannot show that he or she impartially investigated the options, the court would be more willing to find an abuse of discretion in failing to divest the plan of the ailing employer securities.

INSIDER INFORMATION/COORDINATION BETWEEN SECURITIES LAWS AND ERISA

The Enron litigation raised issues regarding the duties of fiduciaries with respect to investments in employer securities. There are situations where the fiduciary, as an insider of the company (e.g., an officer), has knowledge of information that raises legitimate questions about the prudence of such investments, including the retention of employer securities as an investment option in a participant-directed plan, and an affirmative duty to inform participants. The DOL filed an amicus brief in the Enron legislation that raised these issues.

In *Tittle v. Enron*,[93] the district court endorsed the view of the DOL that disclosure duties under ERISA and obligations under the securities law must both be satisfied. A fiduciary under ERISA, who also is subject to duties under the securities law, must take reasonable steps to act in a manner that is consistent with the obligations under both sets of laws. The amicus brief was cited with approval by the district court in the WorldCom case that similarly declined to dismiss claims against fiduciaries merely because of a potential conflict between the defendants' obligations under federal security laws and under ERISA.[94]

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[92] See *Moench v. Robertson*, 62 F.3d 553 (3rd Cir. 1995) (employer's stock price fell from $18.25 per share to less than 25¢ per share); *Kirschbaum v. Reliant Energy, Inc*., 526 F.3d 243 (5th Cir. 2008); *Kuper v. Iovenko* (Quantum Chemical Corp.), 66 F.3d 1447 (19 EBC 1969) (6th Cir. 1995) (price of securities fell over an 18-month period); and *Quan v. Computer Sciences Corporation*, 623 F.3d 870 (49 EBC 2642 (6th Cir. 1995).
[93] 31 EBC 2281 (S.D.Tex. 2003).
[94] *Rankin v. Rots*, 278 F.Supp.2d 853, 30 EBC 2761 (E.D.Mich. 2003)

Following Governing Documents

A fiduciary must carry out his or her duties in accordance with the documents and instruments that govern the plan.[95] Note that the governing documents are not limited solely to the formal document that is identified as the plan. For example, even though the SPD is primarily intended to communicate a summary of the plan to participants, it has been viewed by the courts as part of the governing documents.[96] This may lead to conflicts between the plan document and the SPD that need to be resolved. In a 2011 case, *Cigna v. Amara*,[97] the Supreme Court stated that the SPD is not part of the governing plan documents, particularly because the plan sponsor adopts the plan document, but the plan administrator is responsible for preparing and providing the SPD to the participants. The Court noted that ERISA did not intend to permit someone other than the plan sponsor to co-opt the responsibility and authority to amend the plan. Furthermore, the Court noted that interpreting the SPD to be part of the plan would surely lead to more legalese and less understandable participant disclosures. Nonetheless, even in light of Amara, a properly drafted SPD should probably contain a statement that, in the event of a conflict, the plan document provision will prevail.

Document Must Be Consistent with ERISA

The rule that the plan document must be followed does not apply to the extent the governing document is contrary to Title I or Title IV of ERISA. The fiduciary has a duty to determine whether the governing documents are contrary to ERISA and, if so, a duty to act in a manner consistent with the applicable ERISA standard. The prudence standard would apply in assessing whether the fiduciary acted reasonably in following or failing to follow the terms of the plan or other relevant plan instrument.

Interpretation of the Plan Document

The plan administrator is generally charged with the responsibility of interpreting the plan document. In some cases, the document will be ambiguous or unclear with respect to a certain issue, and the administrator must make a prudent decision regarding the proper administration of the plan.

The standard of review regarding a challenge to the administrator's interpretation of the document was established by the Supreme Court in *Firestone Tire & Rubber Co. v. Bruch*.[98] If the plan expressly gives the administrator or other fiduciary the discretionary authority to interpret the plan, then an abuse of discretion standard of review applies.

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[95] ERISA §404(a)(1)(D).
[96] *Bergt v. Retirement Plan For Pilots Employed By MarkAir, Inc*., 28 EBC 1398 (9th Cir. 2002).
[97] *Cigna Corp. v. Amara* 563 US __, 131 S. Ct. 1866, 50 EBC 2569 (2011).
[98] 489 U.S. 101 (1989); See also, *Conkright v. Frommert*, 130 S.Ct. 1640, 48 EBC 2569 (2010), confirming that the standard of review remains arbitrary and capricious even if the fiduciary has made an error previously. This case is noteworthy for the finding, as well as its opening sentences, which state axiomatically, "People make mistakes. Even administrators of ERISA plans."

Historically, conflicts between the plan document and the SPD were often resolved in favor of the affected employees. In many cases, the language in the SPD was the one more favorable, and was considered by the court to "trump" the plan language, but in other cases the plan document is more favorable.[99] This line of cases was likely made obsolete by the ruling in *Cigna v. Amara*, discussed above, in which the Supreme Court clarified that the SPD is not part of the plan document.

8.04: Fiduciary Liability

In the previous section we discussed the standards that a fiduciary is held to in carrying out his or her responsibilities under the plan. This section turns to the liability issues. In determining whether and to what extent a fiduciary is liable, the courts will focus on the fiduciary's conduct under the circumstances, whether such conduct satisfied the ERISA fiduciary standards and what loss or other harm has been incurred as a result of any breach in those fiduciary standards.

DIRECT RESPONSIBILITY

A fiduciary is personally liable for any breach of responsibility that he or she directly commits, either by act or omission.[100]

Restoration of Losses

The fiduciary must restore losses incurred by the plan because of the breach. The obvious losses are those due to imprudent investing or failure to diversify investments as required by ERISA.

Mismanagement of the plan can also result in losses. For example, a plan administrator's imprudent administration of the plan's participant loan program might result in an investment loss to the plan, such as a loan held as a general plan investment, where other participants are at risk, and which is made to a participant who could not reasonably be expected to repay the loan.

Several federal circuits have held that, in measuring the loss to a plan, the burden of persuasion is placed on the breaching fiduciary when the amount of loss is ambiguous or in doubt.[101]

Disgorgement of Profits

The fiduciary may be required to pay to the plan any profits he or she earned through the use of plan assets in the breach. Courts have required a fiduciary to disgorge profits to the plan even in a situation where, in spite of the breach, the plan realized a gain from the transaction. See, for

[99] *Bergt v. Retirement Plan For Pilots Employed By MarkAir, Inc*., 293 F.3d 1139, 28 EBC 1398 (9th Cir. 2002). (more favorable eligibility language in plan controlled over conflicting language in SPD; extrinsic language not considered where language in both documents is unambiguous but conflicting).
[100] ERISA §409.
[101] *Kim v. Fujikawa*, 871 F.2d 1427(10 EBC 2382) (9th Cir.1989), *Roth v. Sawyer-Cleator Lumber Co*., 61 F.3d 599 (19 EBC 1641) (8th Cir.1995), and *Secretary of Labor v. Gilley*, 27 EBC 2569 (6th Cir. 2002).

example, *Leigh v. Engle*,[102] in which the plan's investments produced a 72 percent gain as a result of the breach, yet the breaching fiduciaries had to turn over their personal profits to the plan.

Other Relief Available under ERISA

A court may award other equitable or remedial relief as it determines is appropriate to compensate the plan for the effects of the breach.

Under certain circumstances, a plan may offset damages against a fiduciary-participant's benefit under the plan in which the breach occurred.[103]

CO-FIDUCIARY LIABILITY

A fiduciary is liable for another fiduciary's breach under certain circumstances.[104] Through co-fiduciary liability, a fiduciary with more money or assets than another may ultimately be responsible for restoring a loss to the plan (or to the participant or beneficiary), rather than the fiduciary who was directly liable for the breach. This gives the ERISA plaintiff a choice of defendants and a better chance of obtaining recovery.

Knowing Participation or Concealment

If a fiduciary knowingly participates in or knowingly conceals an act or omission of another fiduciary, knowing that the act or omission is a breach, the fiduciary may be held liable for such breach.[105]

Enabling a Breach to Occur

If, by failing to comply with his or her duties under ERISA §404(a)(1), the fiduciary has enabled another fiduciary to commit a breach, the fiduciary may be held liable for that breach.[106]

EXAMPLE 8-3. Enabling a Breach. R is the plan administrator of a profit-sharing plan. R appointed S to manage one of the plan's investment funds pursuant to allocation provisions in the plan. R did not prudently monitor S's activities. S invests in numerous speculative investments that are contrary to the governing investment policy for the fund, resulting in losses to the plan. R may have co-fiduciary liability for S's breach because R's inattention to S's actions likely enabled the breach to occur.

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[102] 727 F.2d 113 (7th Cir.1984).
[103] ERISA §206(d)(4).
[104] ERISA §405.
[105] ERISA §405(a)(1).
[106] ERISA §405(a)(2).

No Reasonable Steps Taken to Remedy Situation

If the fiduciary has knowledge of a breach by another fiduciary and does not make reasonable efforts under the circumstances to remedy the breach, the fiduciary may be liable for that breach.[107] Reasonable efforts might include notifying other plan fiduciaries or the DOL.[108]

If the fiduciary with knowledge of a breach is a trustee, mere resignation as a trustee may not be enough to avoid co-fiduciary liability. In the DOL's view, mere resignation without taking steps to prevent an imprudent action will not suffice to avoid liability for the fiduciary once he or she has knowledge that the imprudent action is under consideration.

Loss Must Result from Co-Fiduciary's Failure

For a fiduciary to be held liable under the co-fiduciary liability provisions rather than for direct liability, the loss sustained must result from the co-fiduciary's failure. In *Silverman v. Mutual Benefit*,[109] the plaintiff brought an action for co-fiduciary liability against an insurer (Principal) that was named by the plan administrator to replace the former group annuity insurer. There was no indication of wrongdoing at the onset of the relationship between the plan and Principal. However, only part of the funds obtained from the cancellation of the first contract was sent to Principal and the trustees embezzled the rest. The court ruled that no fiduciary breach can attach under the co-fiduciary liability rules unless the plaintiff shows a causal link between the alleged breach and the loss. The plaintiff had to show:

- Principal had knowledge of the trustees' embezzlement;
- Principal failed to make reasonable efforts to remedy the trustees' breach; and
- The fund's loss resulted from that failure.

Although the court allowed that there may be sufficient facts to satisfy the first two requirements, which would necessitate a trial, the court determined that Principal was entitled to summary judgment because of the third factor. By the time Principal would have had any duty to take action, the trustees had no assets that might have been recovered by the plan.

Investment Manager Appointed

A trustee is not subject to co-fiduciary liability with respect to an investment manager's breach and is not obligated to manage any asset under the investment manager's control.[110] This exception does not relieve the trustee from co-fiduciary liability that arises from knowing participation in or concealment of the investment manager's breach, as described in ERISA §405(a)(1), because that involves affirmative action by the trustee and is more akin to a direct liability concept. The exception protects the trustee from co-fiduciary liability under ERISA

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[107] ERISA §405(a)(3).
[108] DOL Field Assistance Bulletin 2004-03 (December 17, 2004).
[109] DOL Field Assistance Bulletin 2004-03 (December 17, 2004).
[110] ERISA §405(d)(1).

§405(a)(2) (relating to enabling a breach to occur) and under ERISA §405(a)(3) (relating to failure to take reasonable steps to prevent the breach from occurring).[111] However, this exception does not apply to the fiduciary who is responsible for appointing and monitoring the investment manager; those duties remain, and a failure to do so can subject the appointing fiduciary to liability for failing to fulfill those duties (which are direct fiduciary obligations and not co-fiduciary liability). See Example 8-3 above.

Directed Trustee

ERISA specifically permits a trustee to be subject to the proper direction of a named fiduciary. This type of trustee is called a **directed trustee**.[112] The trustee is shielded from liability with respect to such directions.[113] If there is specific authority given to a named fiduciary to direct the trustee, the trustee's liability with respect to those directions is more limited. The trustee's only duty in this situation is not to follow instructions that are contrary to ERISA. Also, the directed trustee's actions or inactions could result in co-fiduciary liability under the principles discussed above.

Sometimes, the trustee will agree to accept investment direction from another party (e.g., the employer) without specific language in the plan requiring the trustee to take such direction. In this case, the trustee retains primary responsibility to manage the plan assets and may be liable for losses due to imprudent investment decisions made by the trustee on a directed basis.

If You're Curious . . .

What is Proper Direction?

One of the most interesting aspects of the *Enron* case, and one that will continue to be looked at closely by the ERISA community, is the issue of co-fiduciary liability for a directed trustee. The DOL filed an amicus brief in the Enron litigation that took the position that a directed trustee still has an obligation to review whether the directions it receives are consistent with the terms of the plan and ERISA, particularly where the directed trustee has knowledge (or should have known) that the directions being given would result in fiduciary breaches. The DOL then published its position on these issues in Field Assistance Bulletin 2004-03.

In its opinion declining to dismiss the ERISA claims against the directed trustee, the district court in *Tittle v. Enron*[114] reviewed various opinions relating to the issue of co-fiduciary liability with respect to a directed trustee. In the court's view, Congress did not intend to release the directed trustee from all liability if the directed trustee follows the directions of a named fiduciary. In the court's eyes, if Congress had intended that, they would have expressly stated so. Instead, the court believes that the directed trustee is

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[111] *Beddall v. State Street Bank and Trust Co.*, 137 F.3d 12 (1st Cir. 1998).
[112] ERISA §403(a).
[113] ERISA §405(b)(3)(B).
[114] 284 F.Supp. 2d 511 (31 EBC 2281) (S.D.Tex. 2003).

relieved only to the extent the directions given by the named fiduciary are consistent with ERISA, because ERISA §404(a)(1)(D) requires a fiduciary to follow the governing documents of the plan only to the extent such documents are not contrary to ERISA. The unresolved legal issues then become whether the directed trustee has a duty to determine whether directions are proper under ERISA, and, if so, how that duty is carried out and what parameters apply to the scope of the directed trustee's evaluation of such directions.

Trustee Designation is an Important Factor

The *Enron* court makes note of the fact that, under the terminology used in ERISA, a trustee remains designated a trustee, even though his or her role is qualified by the adjective "directed." The court interprets this statutory language to support a continuance of fiduciary responsibility, though modified, in the directed trustee who retains a legal interest in the trust and some authority over the plan assets. The trustee's function as the holder of the legal interest in the property of the trust precludes direct action on the trust's assets by the named fiduciary, leading the court to take the view that the directed trustee retains some responsibility to evaluate the directions being made by the named fiduciary.

DOL Publishes its Position on Directed Trustee Responsibilities

In light of the *Enron* case cited above, as well as litigation relating to WorldCom, the DOL published informal guidance on its views on the responsibilities of directed trustees under ERISA, particularly with respect to directions involving employer securities.[115] Although a directed trustee has a more limited scope of fiduciary responsibility than does a discretionary trustee, the directed trustee is always a fiduciary under ERISA because the directed trustee has authority or control over the management or disposition of the trust assets. According to the DOL, a direction given to the directed trustee is proper within the meaning of ERISA §403(a) only if:

1. It is made in accordance with the terms of the plan; and
2. It is not contrary to ERISA.

If the directed trustee knows or *should know* that the direction violates either of these requirements, the trustee may not follow the direction.

In accordance with the plan terms. If the directed trustee receives a direction which is contrary to the terms of the plan, but follows the direction anyway, the directed trustee could be liable for a breach of fiduciary duty. In addition, a directed trustee has a duty to request and review all the documents and instruments governing the plan that are relevant to its duties as directed trustee. Thus, if the directed trustee either fails to request such documents or fails to review the documents, and, as a result of such failure, follows a direction contrary to the terms of the plan, the trustee may be liable for following such direction because the trustee should have known that such direction was not in accordance with the plan.

Not contrary to ERISA. Even if the direction is consistent with the terms of the plan, the direction may fail to be proper if it is contrary to ERISA. In this regard, a directed trustee should not follow a direction that it knows or should know would result in a PT or violate ERISA's prudence requirement.

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[115] DOL Field Assistance Bulletin (FAB) 2004-03 (December 17, 2004).

A directed trustee must follow processes that are designed to avoid a PT. This duty could be satisfied by obtaining appropriate written representations from the directing fiduciary that the plan maintains and follows procedures for identifying a PT and, if applicable, identifying the individual or class exemption applicable to a transaction. The directed trustee may rely on the representations of the directing fiduciary in this regard, unless the directed trustee knows the representations are false.

If the directed trustee possesses material non-public information regarding a security, the DOL believes that the trustee, prior to following a direction that would be affected by such information, has a duty to inquire about the named fiduciary's knowledge and consideration of the information with respect to the direction. For example, if the directed trustee has non-public information indicating that a company's public financial statements contain material misrepresentations that significantly inflate the company's earnings, the trustee may not simply follow a direction to purchase the company's stock at an artificially inflated price.

There is rarely an obligation to question the prudence of a direction to purchase publicly traded securities at the market price solely on the basis of publicly available information. The DOL also acknowledges that, because stock prices fluctuate, even a steep drop in a stock's price would not, in and of itself, indicate that a named fiduciary's direction to purchase or hold such stock is imprudent and, therefore, not a proper direction. In limited, extraordinary circumstances, where there are clear and compelling public indicators that call into serious question a company's viability as an ongoing concern, the directed trustee may have a duty not to follow the named fiduciary's instruction without further inquiry. As an example, if a company filed for bankruptcy under circumstances that make it unlikely to survive the bankruptcy proceedings in a manner that would leave current equity holders with any value, the directed trustee would have an obligation to question whether the named fiduciary has considered the prudence of the direction.

The DOL notes that, if a corporate employee gives a direction to buy or hold stock of his or her employer after the company (via its officers or its directors) is formally charged by state or federal regulators with financial irregularities, the directed trustee may need to decline to follow the direction, or may need to conduct an independent assessment. However, if an independent fiduciary (i.e., independent of the employer) was appointed to manage a plan's investment in company stock, a directed trustee could follow the proper directions of the independent fiduciary without having to conduct its own independent assessment of the transaction.

Directed Trustee's Status Does Not Change by Complying with its ERISA Duties

The DOL notes that a directed trustee does not change the nature or scope of its fiduciary responsibilities merely because, in carrying out its ERISA duties, it raises questions concerning whether a direction is proper, or declines to follow a direction that the directed trustee does not believe is proper. For example, information provided by the directed trustee to a named fiduciary concerning the prudence of a direction is not investment advice for purposes of ERISA §3(21)(A)(ii). Also, if a named fiduciary changes a direction in response to a directed trustee's inquiries or information, the directed trustee does not become primarily responsible for the prudence of that direction, and the scope of the directed trustee's duties remains governed by ERISA §403(a)(1).

Co-Fiduciary Liability Concerns for Directed Trustees

A directed trustee is subject to ERISA's co-fiduciary liability provisions. If a directed trustee has actual knowledge of a fiduciary breach, even if that breach does not concern directions given to the directed trustee, the directed trustee may have co-fiduciary liability unless the directed trustee takes reasonable steps to remedy the breach. Taking reasonable steps does not mean simply refusing to follow directions from a breaching fiduciary. See DOL Field Assistance Bulletin 2004-03, where the DOL notes that efforts to remedy a breach or to prevent an imminent breach might include reporting the breach to other fiduciaries of the plan or to the DOL.

SUCCESSOR FIDUCIARY

ERISA §409(b) provides that "no fiduciary shall be liable with respect to a breach of fiduciary duty under this title if such breach was committed before he became a fiduciary or after he ceased to be a fiduciary." Nonetheless, a successor trustee or other **successor fiduciary** may find themselves liable for continuing breaches that may have originated with a prior fiduciary, but which the current trustee or fiduciary does not take prudent steps to remedy. Also, the co-fiduciary liability provisions may result in liability for acts or omissions of a prior fiduciary in which the successor may be found to have participated in or failed to take prudent actions to remedy.

Breaches Committed Before Individual Became Fiduciary

In *Barker v. American Mobil Power Corp.*,[116] plan funds had been transferred to company accounts before one of the defendants (Ayres) became a fiduciary. He was also a participant in the plan. Ayres became aware of these earlier transactions in the 1980s, and, as far as he knew, the funds were never repaid. Ayres also suspected plan funds were being commingled with company assets and benefits were being paid out of the company's operating funds. He did not conduct any investigation or inquiry regarding these suspicions, nor did he alert plan participants. During this period, he signed annual benefit statements that indicated the plan funds were being held in trust for the participants' benefit. The court concluded that Ayres breached his fiduciary duty with respect to the plan participants.

Successor Trustee had Duty to Review Trust Investments

In *Morrissey v. Curran*,[117] the court ruled that a successor trustee has a fiduciary duty to review trust investments and determine whether any corrective action is required.

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[116] 64 F.3d 1397 (9th Cir. 1995).
[117] 567 F.2d 546 (2nd Cir. 1977).

NONFIDUCIARY CANNOT BE LIABLE FOR FIDUCIARY BREACH

The Supreme Court ruled in *Mertens v. Hewitt Associates*[118] that a nonfiduciary cannot be held liable under ERISA for a fiduciary's breach. However, nonfiduciaries can be sued under ERISA for participation in PTs.[119] In addition, service providers who are negligent in performing nonfiduciary services are subject to possible state law or common law claims that, in most cases, are not preempted by ERISA.

ERISA §502(L) PENALTY

A fiduciary (or other person) is liable for a civil penalty in the amount of 20 percent of the applicable recovery amount in a settlement agreement with the DOL or in a court proceeding brought by the DOL under ERISA §502(a)(2) or under ERISA §502(a)(5).[120] The **applicable recovery amount** is the amount recovered from the fiduciary or any other person. The **20 percent civil penalty** may arise when the fiduciary breaches his or her fiduciary responsibility or otherwise violates Part 4 of Title I, or knowingly participates in a breach or other fiduciary violation under Title I by another person. This will include violations of the PT rules in ERISA §406. Participation in a PT is the primary violation of ERISA for which a nonfiduciary might be held liable for an ERISA §502(l) penalty, because PTs can involve the participation of persons other than fiduciaries.[121] The penalty under ERISA §502(l) is reduced by any PT excise tax under IRC §4975 or DOL civil penalty under ERISA §502(i), relating to a PT, which is imposed on the fiduciary or other person involved in the transaction. The penalty may be waived or reduced if the fiduciary (or other person) acted in good faith, and it is reasonable to expect the fiduciary will not be able to restore all losses to the plan without severe financial hardship if the penalty were paid.

In *Rodrigues v. Herman*,[122] a fiduciary suit was settled by a consent decree under which the trustee (Rodrigues) did not admit wrongdoing. The court concluded that, even viewing the facts in the light most favorable to Rodrigues, he clearly breached his fiduciary duty to the plan. Therefore, an ERISA §502(l) penalty could be imposed, even though the consent decree does not admit wrongdoing on the part of the fiduciary.

Determining Applicable Recovery Amount

Sometimes the applicable recovery amount is not clear. In the *Rodrigues* case, the fiduciary argued that, because he did not have to pay any out-of-pocket amount to the plans, there was no recovery amount for purposes of calculating the 20 percent penalty. However, the consent decree involved the equitable transfer of partnership interests to the plan that Rodrigues had acquired

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[118] 113 S.Ct. 2063 (1993).
[119] *Harris Trust and Savings Bank v. Salomon Brothers, Inc*., 24 EBC 1654 (Sup.Ct. 2000).
[120] ERISA §502(l).
[121] *Harris Trust and Savings Bank v. Salomon Brothers, Inc.*, 24 EBC 1654 (Sup.Ct. 2000).
[122] 121 F.3d 1352 (9th Cir. 1997).

with plan assets but had never titled in the plan's name. The court ruled that the value of the transferred property constitutes an applicable recovery amount against which the ERISA §502(l) penalty may be assessed.

DOL Investigations May Result in Settlement Where Penalty is Imposed

The DOL conducts investigations of ERISA violations through the Employee Benefits Security Administration (EBSA) (formerly known as the Pension and Welfare Benefits Administration (PWBA)). In an investigation, the DOL may issue a voluntary compliance notice letter to a fiduciary. This letter cites the ERISA violations that the DOL has uncovered, and requests correction. Because ERISA §502(l) can apply to a recovery obtained through a settlement, a fiduciary should discuss with legal counsel the ramifications of responding to a voluntary compliance notice letter. See, for example, *Citywide Bank of Denver v. Herman*,[123] where a court held that the ERISA §502(l) penalty did not apply merely because, upon receipt of a DOL letter issued after an ERISA investigation, the fiduciary unilaterally took corrective steps that were described in that letter. The voluntary actions of the fiduciary were not treated by the court as a settlement between the fiduciary and the DOL that would give rise to the penalty.

Penalty Does Not Apply if Breach is Corrected Under VFC Program

A fiduciary that corrects a breach through the DOL's Voluntary Fiduciary Correction (VFC) Program is not subject to the ERISA §502(l) penalty;[124] only breaches that are eligible for relief, as stated in section 7 of the VFC Program, may qualify for ERISA §502(l) penalty relief under that program.

Exculpatory Provisions, Liability Insurance and Indemnification Arrangements

Any agreement or instrument that purports to relieve a fiduciary from responsibility or liability (i.e., an exculpatory provision) is void.[125] In spite of this broad statement, certain insurance and indemnification arrangements are permitted.

Purchase of Liability Insurance

The following may purchase insurance to cover liability or losses by reason of the act or omission of a fiduciary; however, the insurance must permit recourse by the insurer against the fiduciary:[126]

- The plan.

[123] 978 F.Supp. 966 (D.Colo. 1997).
[124] Section 2(a) of the VFC Program, 67 F.R. 15061 (March 28, 2002).
[125] ERISA §410.
[126] ERISA §410(b)(1).

- A fiduciary may purchase liability insurance with his or her own funds.[127]
- The employer or employee organization (e.g., union) may purchase insurance to cover the potential liability of a fiduciary.[128]

Indemnification Agreement

An indemnification agreement is permitted under which another party (e.g., the employer) agrees to satisfy any liability incurred by a fiduciary.[129] The agreement must leave the fiduciary fully responsible and liable. See *Martin v. NationsBank of Georgia, N.A.*,[130] where an indemnification agreement was ruled invalid on its face because the way it was structured gave the trustee financial incentive not to exercise its independent judgment.

Contractual Agreement to Limit Liability of Service Provider

The DOL had occasion to consider the acceptability of limitation of liability clauses in service provider contracts.[131] The situation presented in the letter involved an actuarial firm that required all new engagement letters to contain limitation of liability and indemnification provisions. Although the DOL stated in Advisory Opinion 2002-08A that it believes that such provisions, in and of themselves, are not per se imprudent under ERISA, nor in violation of the PT rules, it cautioned the plan that the responsible plan fiduciary must consider the liability limitation provision in the context of all other factors in determining the reasonableness of the services arrangement and the potential risks to participants and beneficiaries. At a minimum, compliance with ERISA’s fiduciary standards would require the fiduciary to assess the plan’s ability to obtain comparable services at comparable costs without having to agree to such provisions, or from service providers who have provisions that provide greater protection to the plan.

Persons May Seek Money Judgments Against the Plan for Liability Arising from the Plan’s Activities

A plan may sue or be sued in its own capacity as an entity.[132] Because the plan can be sued as an entity, it can be liable for damages resulting from its activities. Prudence would dictate that a fiduciary consider any liability that could arise from investments being made by the plan. ERISA §502(d)(2) provides that a money judgment against the plan is enforceable only against the plan. However, a money judgment against the plan could be treated as a loss for which a fiduciary is responsible, if it is determined that the responsible fiduciary did not act prudently in proceeding with the activity on behalf of the plan which resulted in the money judgment. If there is evidence of fiduciary imprudence, a separate action would have to be brought against the fiduciary, pursuant to ERISA §502, to recover for such loss.

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[127] ERISA §410(b)(2).
[128] ERISA §410(b)(3).
[129] DOL Reg. §2509.75-4.
[130] 16 EBC 2138 (N.D.Ga. 1993).
[131] Advisory Opinion 2002-08A.
[132] ERISA §502(d).

8.05: Review of Key Concepts

- Define a fiduciary and identify parties who serve as fiduciaries.
- What are the three aspects to being a fiduciary for an individual who gives investment advice to a plan?
- What is the difference between discretionary authority or responsibility and the performance of ministerial functions?
- What is a named fiduciary? How do the powers and responsibilities of a named fiduciary differ from those of other designated fiduciaries?
- What is an investment manager according to ERISA? Who may appoint an investment manager? Who may serve as an investment manager?
- What is a directed trustee? What fiduciary responsibilities does a directed trustee have?
- When may a fiduciary receive compensation from a plan?
- If a person is convicted of a crime, what limitations are placed on the relationship that the person may have with a qualified plan?
- What is an investment policy statement?
- What are the bonding requirements for a qualified plan? Who must be bonded, and what is the minimum amount of the bond?
- What is the exclusive purpose rule?
- Explain the prudence standard.
- What is the diversification standard?
- What are some of the key factors that a fiduciary should consider when choosing a service provider?
- When is a fiduciary personally liable to the plan?
- What is co-fiduciary liability and under what circumstances does it apply?
- Under what circumstances may a successor fiduciary be liable for fiduciary breaches committed before he or she became a fiduciary?
- Can a nonfiduciary be held liable for a fiduciary breach?
- When does the 20 percent civil penalty apply to a fiduciary?
- Under what circumstances may a plan, a fiduciary, an employer or an employee organization purchase insurance to cover the losses resulting from a fiduciary breach?
- When may a fiduciary permit a service provider to include a limitation of liability clause in its service contract?

8.06: For Practice – True or False

1. A person who actually exercises control of the plan’s management, but is not authorized to do so, is a fiduciary.

2. An employer that sponsors a qualified retirement plan is a fiduciary as a result of its role as settlor of the trust.

3. When plan assets are invested in contracts issued by an insurance company, the insurance company becomes a fiduciary since it manages the assets that provide the benefits under the plan.

4. If a plan does not specify a named fiduciary, it must provide a procedure for identifying a named fiduciary.
5. An investment manager includes any person who acts in a fiduciary capacity with respect to plan assets.
6. A person may serve in more than one fiduciary capacity in a plan.
7. A plan must identify the persons with authority to amend the plan.
8. An investment policy statement must be adopted to provide instructions to the fiduciaries regarding the investment of plan assets.
9. If a trustee discovers a breach of fiduciary liability by a co-fiduciary, the best course of action is to resign as trustee.
10. A plan, a fiduciary or an employer may purchase insurance to cover liability or losses by reason of a fiduciary breach.

8.07: Sample Test Questions

1. All of the following individuals are fiduciaries with respect to a plan, EXCEPT:
   A. An individual who exercises discretionary authority over the plan's participant loan program.
   B. An individual who exercises control over the purchase and sale of plan assets.
   C. An individual who provides investment advice for a fee with respect to plan funds.
   D. An individual who prepares audited financial statements of the plan assets.
   E. An individual who determines which participants are eligible to receive benefits and authorizes the payment of such benefits.

2. All of the following statements regarding fiduciary liability are TRUE, EXCEPT:

   A. Any agreement containing exculpatory provisions that attempt to relieve a fiduciary from liability is void under ERISA.
   B. A fiduciary that approves a limitation of liability clause in a service provider contract is personally liable for any losses that exceed the liability limitations.
   C. A plan may purchase insurance that will reimburse the plan for any losses suffered as a result of a fiduciary breach.
   D. An employer or other party may indemnify a fiduciary, provided the fiduciary remains responsible for any breaches committed as a fiduciary.
   E. A fiduciary may purchase liability insurance with his or her own funds.

3. All of the following are fiduciary functions, EXCEPT:

   A. Determining eligibility for the plan
   B. Reviewing claims for plan benefits
   C. Paying PBGC premiums
   D. Maintaining plan records according to ERISA requirements

E. Hiring an investment manager

4. All of the following statements regarding consequences of fiduciary breaches are TRUE, EXCEPT:
    A. Fiduciaries must restore losses incurred by the plan due to a failure to diversify investments.
    B. A fiduciary will not be held liable for a breach made by the investment manager.
    C. A fiduciary's account balance in the plan may be used to offset damages to the plan if necessary.
    D. A fiduciary may be required to pay any profits earned in a breach to the plan.
    E. Fiduciaries must restore losses incurred by the plan due to mismanagement of the plan.

5. All of the following factors should be considered when choosing a service provider, EXCEPT:
    A. Fees charged for services to be performed
    B. Qualifications of the service provider
    C. Quality of the services to be performed
    D. Litigation or enforcement action taken against the service provider
    E. Design of the service provider's office

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

8.08: Solutions to True or False Questions

1. True.
2. False. An employer does not become a fiduciary by nature of its role as settlor of the trust since settlor functions are nonfiduciary in nature. However, an employer typically becomes a fiduciary when it takes on the role of plan administrator or other roles under which it has discretion over the management of plan administration and investments.
3. False. Plan assets are deemed not to include the underlying assets of an insurance company with respect to a contract issued by an insurer to an employee benefit plan.
4. True.
5. False. Investment manager is an ERISA term that refers to a fiduciary who has the power to manage, acquire or dispose of any plan assets, and who has acknowledged fiduciary status in writing. ERISA permits only certain types of entities to act as investment managers, and only a named fiduciary may appoint an investment manager.
6. True.
7. False. The plan must provide a procedure for identifying the persons with authority to amend the plan. A reference to "the Company" satisfies the request to identify the persons with authority to amend the plan.
8. False. A plan must provide a procedure for establishing and implementing a funding policy. However, it need not adopt an investment policy statement, although it may be advisable to do so. An investment policy statement provides general instructions or guidelines applicable to investment situations.
9. False. Resignation of a trustee may not be sufficient to avoid liability when the trustee has knowledge of a breach. The trustee must take steps to remedy the breach.
10. True.

8.09: Solutions to Sample Test Questions

1. The answer is **D**. The preparation of financial statements by the plan's auditor is not a fiduciary function.

2. The answer is **B**. A fiduciary must consider the liability limitation in a service provider contract in the context of all other factors in determining the reasonableness of the agreement and the potential risks to participants. If the liability limitation is reasonable, then the fiduciary is not necessarily liable for losses in excess of the liability limitation.

3. The answer is **C**. Paying PBGC premiums is a settlor function, not a fiduciary function.

4. The answer is **B**. A fiduciary may be subject to co-fiduciary liability with respect to an investment manager's breach of fiduciary duties if the fiduciary hired said investment manager and did not monitor the investment manager's activities.

5. The answer is **E**. The design of the service provider's office is not a factor to consider in choosing a service provider.

CHAPTER 9:

PROHIBITED TRANSACTIONS

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9.01: Key Terms

- 12b-1 fees
- 20 percent penalty
- Class exemption
- Disqualified person
- Initial tax
- Party-in-interest
- Prohibited transactions (PTs)
- Regulatory exemptions
- Second tier tax
- Statutory exemptions

9.02: Introduction

In the prior chapter, we discussed the responsibilities that fiduciaries owe the plan and its participants and beneficiaries. The Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC) go one step further in protecting the rights of those who are supposed to benefit under the plan by outlining certain transactions that cannot be entered into by the plan if the other party to the transaction has too close a relationship to the plan. Here, Congress concentrated not only on plan fiduciaries, but also on others who have responsibilities to the plan. These types of people are called **disqualified persons** in the IRC and parties-in-interest in ERISA (both terms are defined later in the chapter). These restricted transactions are called, appropriately enough, **prohibited transactions (PTs)**.

PTs are dealt with in the IRC, as well as in Title I of ERISA. The purpose of the PT rules is to protect the interests of plan participants by prohibiting dealings between the plan and persons who may have conflicts of interest with the plan. Although a transaction that is prohibited might actually benefit the plan participants, the transaction is, nonetheless, prohibited because the nature of the relationship between the plan and the person engaging in the PT is one that has an increased likelihood of causing potential harm to the plan. In other words, the PT rules are designed to avoid even the appearance of an impropriety on the part of those with a relationship with the plan.

STATUTORY AUTHORITY

The primary statutory provisions for PTs are IRC §4975 and ERISA §§406, 407 and 408.

Internal Revenue Code Provisions

IRC §4975 imposes an excise tax on a disqualified person who engages in a PT with the plan.

ERISA Provisions

ERISA §406	Prohibits a fiduciary from engaging in a PT with a party-in-interest. A PT is defined in ERISA §406 and parallels the definition in IRC §4975(c). As noted, ERISA uses the term party-in-interest (defined in ERISA §3(14)), rather than disqualified person, to identify PTs for Title I purposes.
ERISA §407	Permits certain investments by a plan in securities issued by the employer and in real property leased back to the employer.
ERISA §408	Provides statutory exemptions to the PT rules which parallel those found in IRC §4975(d).

EXEMPTIONS

Some transactions that would customarily be prohibited are, nonetheless, valuable to a plan or to the participants. The law provides the following three means through which certain otherwise prohibited transactions can be exempted from those rules:

1. There are certain exemptions that were written into the law (**statutory exemptions**).
2. The Department of Labor (DOL) has provided some exemptions from the PT rules in regulations (**regulatory exemptions**).
3. The PT procedures permit an individual plan trustee or sponsor to apply to the DOL for exemption of a given transaction (an **individual exemption**). In addition, the procedures permit the DOL to make some of these exemptions generally available to all parties-in-interest (a **class exemption**).

We will be discussing some of these PT exemptions in this chapter. However, please keep in mind that this is a survey of PT rules. Therefore, we may not review all of the specific requirements or nuances of an exemption. Be sure to review the actual exemption before applying these rules to a plan.

PENALTY FOR PROHIBITED TRANSACTIONS

If a party-in-interest or disqualified person enters into a PT, he or she is required to reverse the transaction in such a way as to put the plan back into the condition it would have been in if the transaction had not taken place. Furthermore, the party-in-interest or disqualified person is subject to excise taxation by the IRS. Finally, a fiduciary that permits the plan to enter into a PT may be considered to have breached his or her duties.

9.03: Disqualified Person and Party-in-Interest

DISQUALIFIED PERSON

A disqualified person under IRC §4975 includes anyone in the following categories. The parenthetical information refers to the subsections of IRC §4975(e)(2) where disqualified person is defined.

Fiduciary (Category A)

A fiduciary of the plan is a disqualified person.[1] This would include the trustee(s) and the plan administrator. A participant is treated as a fiduciary with respect to a participant-directed account, but solely for purposes of IRC §4975.[2]

Service Provider (Category B)

A person providing services to the plan is a disqualified person.[3] This would include a third-party administration firm that provides recordkeeping, reporting and compliance testing services. Other examples of service providers include law firms, accounting firms, actuarial firms, brokerage firms, custodians and pension consultants.

Employer (Category C)

An employer whose employees are covered by the plan is a disqualified person.[4]

Employees' Representative (Category D)

An employee organization (e.g., union) that represents employees covered by the plan is a disqualified person.[5]

Substantial Owner of Employer or Employees' Representative (Category E)

An owner of 50 percent or more of an employer or of an organization representing employees (i.e., Category C or D) is a disqualified person.[6] Ownership for this purpose includes indirect ownership under the IRC §267 attribution rules (which will be discussed below).[7]

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[1] IRC §4975(e)(2)(A).
[2] *Flahertys Arden Bowl, Inc. v. Commissioner*, 115 T.C. 269 (Tax Ct. 2000), affirmed, 2001 U.S. App. LEXIS 24557 (8th Cir. 2001).
[3] IRC §4975(e)(2)(B).
[4] IRC §4975(e)(2)(C).
[5] IRC §4975(e)(2)(D).
[6] IRC §4975(e)(2)(E).
[7] IRC §4975(e)(4) and (6).

Family Members (Category F)

A family member of a fiduciary, of a service provider, of an employer or of a substantial owner (i.e., Categories A, B, C or E) is a disqualified person.[8] An individual's family includes his or her spouse, ancestor, lineal descendant and any spouse of a lineal descendant.[9]

Certain Substantially-Owned Organizations (Category G)

A corporation, partnership, trust or estate that is owned 50 percent or more by a fiduciary, service provider, employer, employee organization or a substantial owner (i.e., Categories A, B, C, D or E) is a disqualified person.[10] For example, assume a fiduciary of the plan is a 60 percent shareholder in Corporation X. Corporation X is a disqualified person. The 50 percent ownership requirement is determined in the same manner as for substantial owners of the employer and employee organization, including the application of the IRC §267 attribution rules.

Certain Officers, Directors, Owners or Highly Compensated Employees (Category H)

An officer, director, 10 percent or more shareholder or a highly compensated employee of an employer, employee organization, substantial owner or substantially-owned organization (i.e., Categories C, D, E or G) is a disqualified person.[11]

Certain Partners (Category I)

A 10 percent or more (in capital or profits) partner or joint venturer of an employer, employee organization, substantial owner or substantially-owned organization (i.e., Categories C, D, E or G) is a disqualified person.[12]

Exception: Entity Owned by the Plan

An entity that is wholly owned by a qualified plan is not a disqualified person. This is because the plan owns all of the stock, because none of the categories described above applies to such an entity.

IRC §267(C) ATTRIBUTION

The IRC §267(c) attribution rules are written in terms of stock ownership. However, under the qualified plan rules that use IRC §267(c) attribution, the organization affected by the rules might not be a corporation. In that case, the IRC §267(c) attribution rules are applied to the partnership interest, in the case of a partnership, the membership interests, in the case of a limited liability

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8 IRC §4975(e)(2)(F).
9 IRC §4975(e)(6).
10 IRC §4975(e)(2)(G).
11 IRC §4975(e)(2)(H).
12 IRC §4975(e)(2)(I).

company, or the sole proprietorship interest, in the case of a sole proprietorship. A sole proprietor is treated as the 100 percent owner of his or her business.

Family Attribution

An individual is treated as owning any interest that is owned directly or indirectly by any of the individual's family members.[13] An individual's family members are his or her spouse, brothers and sisters, ancestors and lineal descendants.[14] This is the only family attribution rule that includes brothers and sisters.

To determine whether a corporation, trust or partnership is a disqualified person under Category E or G above, this attribution rule is applied by substituting the following definition of family: spouse, ancestor, lineal descendant and any spouse of a lineal descendant.[15] This alternative definition omits the reference to siblings.

Attribution from an Organization to its Owners or Beneficiaries

An interest owned by a corporation, partnership, estate or trust is considered owned proportionately by its shareholders, partners or beneficiaries.[16] This attribution applies to all owners of the organization, regardless of their respective ownership percentages. For example, assume Corporation X owns a 50 percent interest in Corporation Y. Rocco is a 10 percent shareholder of Corporation X. Rocco is attributed 10 percent of Corporation X's 50 percent ownership in Corporation Y. Rocco is deemed to own 5 percent of Corporation Y.

Any interest attributed to a person from a corporation, partnership or trust is treated as owned by the person for purposes of applying the other attribution rules. In the prior example, Rocco's family members would be attributed the 5 percent ownership in Corporation Y that Rocco was attributed from Corporation X.

Partners

If a partner owns an interest in another organization, that interest is attributed to his or her other partners.[17] For example, assume Morris is a partner in Partnership Z. There are six other partners of Partnership Z. Morris owns 60 percent of the stock of Corporation W. Morris' six other partners in Partnership Z are attributed Morris' ownership in Corporation W.

[13] IRC §267(c)(2).
[14] IRC §267(c)(4).
[15] IRC §4975(e)(4), (5) and (6).
[16] IRC §267(c)(1).
[17] IRC §267(c)(3).

Double Attribution Prohibited Under Certain Circumstances

An interest that is imputed from one person to another by family or partner attribution is not considered to be owned by another relative again by reason of those provisions.[18] For example, if a father is considered to own an interest that belongs to his son, such interest is not then attributed a second time to the father's brother. This prohibition on double attribution would apply in the same manner as with affiliated service groups under IRC §318, as discussed in Chapter 3.

PARTY-IN-INTEREST

A **party-in-interest** is defined in ERISA §3(14) for purposes of applying the PT rules under Title I of ERISA. The party-in-interest definition is almost identical to the disqualified person definition. The differences are rooted in the enforcement distinctions between the IRC and ERISA. The disqualified person definition is more restrictive because IRC §4975 taxes the disqualified person for engaging in the PT. ERISA §406 prohibits the fiduciary from engaging the plan in a transaction with a party-in-interest, and the ERISA sanction is generally against the fiduciary for any loss to the plan as a result of the PT.

A party-in-interest is defined as any of the persons described below. Any difference from the disqualified person definition is noted below. The parenthetical information refers to the relevant subsection of ERISA §3(14), as opposed to IRC §4975(e)(2).

Fiduciary, Counsel or Employee of Plan (ERISA Category A)

A fiduciary, counsel or employee of the employee benefit plan is a party-in-interest.[19] A fiduciary for this purpose includes, but is not limited to, any administrator, officer, trustee or custodian. The word "counsel" in this context is undefined, but is presumed to mean the lawyer for the plan, as opposed to other individuals who may provide advice to the plan. (However, it is likely that any other service provider to the plan will be considered to be a party-in-interest under the Category B.) It is also noteworthy that the reference here to "employee" is someone who is employed *by the plan*. Employees of the plan sponsor are addressed in Category H below.

The disqualified person definition only includes a fiduciary under this category.

As mentioned earlier, if a participant exercises control over the investment of his or her account, the participant is treated as a fiduciary for IRC purposes but not for Title I purposes (i.e., the party-in-interest definition).[20]

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[18] IRC §267(c)(5).
[19] ERISA §3(14)(A).
[20] *Flahertys Arden Bowl, Inc. v. Commissioner*, 115 T.C. 269 (Tax Ct. 2000), affirmed, 2001 U.S. App. LEXIS 24557 (8th Cir. 2001).

Service Provider (ERISA Category B)

A person providing services to the plan is a party-in-interest.[21] This would include a third-party administration firm that provides recordkeeping, reporting and compliance testing services.

Employer (ERISA Category C)

An employer whose employees are covered by the plan is a party-in-interest.[22]

Employees' Representative (ERISA Category D)

An employee organization (e.g., union) that represents employees covered by the plan is a party-in-interest.[23]

Substantial Owner of Employer or Employees' Representative (ERISA Category E)

An owner of 50 percent or more of an employer or of an organization is a party-in-interest.[24] ERISA does not define how indirect ownership should be determined. It should be reasonable to use the IRC §267 attribution rules, as modified by IRC §4975(e)(4) and (6) in the disqualified person definition.

Relatives (ERISA Category F)

A relative of a fiduciary, service provider, employer or substantial owner (i.e., ERISA Categories A, B, C or E) is a party-in-interest.[25] An individual's relatives include his or her spouse, ancestors, lineal descendants and any spouse of a lineal descendant.[26] Note that the disqualified person definition uses the term family members instead of relatives but the terms are defined in the same way.

Certain Substantially Owned Organizations (ERISA Category G)

A corporation, partnership, trust or estate that is owned 50 percent or more by a fiduciary, counsel, employee of the plan, service provider, employer, employee organization or substantial owner (i.e., ERISA Categories A, B, C, D or E) is a party-in-interest.[27]

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[21] ERISA §3(14)(B).
[22] ERISA §3(14)(C).
[23] ERISA §3(14)(D).
[24] ERISA §3(14)(E).
[25] ERISA §3(14)(F).
[26] ERISA §3(15).
[27] ERISA §3(14)(G).

Certain Employees, Officers, Directors or Owners (ERISA Category H)

An employee, officer, director or 10 percent or more shareholder of a service provider, employer, employee organization, substantial owner, substantially-owned organization or employee benefit plan (ERISA Categories B, C, D, E or G) is a party-in-interest.[28] An individual who has power similar to an officer or director, but is not designated as such, is included in this definition. The disqualified person definition does not include an employee in this category, and also does not reference the service provider. However, the disqualified person definition includes a highly compensated employee. Employees or officers of the employee benefit plan are also included in the party-in-interest definition, but not in the disqualified person definition.

Certain Partners (ERISA Category I)

A 10 percent or more (in capital or profits) partner or joint venturer of a service provider, employer, employee organization, substantial owner or substantially-owned organization is a party-in-interest.[29] The disqualified person definition under the IRC does not include the service provider.

9.04: Prohibited Transactions

This section describes the various types of transactions that are prohibited under the IRC and ERISA. The categories of PTs are broadly defined and will encompass most transactions that could occur between the plan and a disqualified person or party-in-interest. When analyzing whether a particular transaction is prohibited, it is important to consider whether any applicable exemptions apply. As discussed above, there are statutory exemptions, which are found in the IRC and/or ERISA, and which may be relied upon as long as the conditions of the exemption are followed. In certain circumstances, the DOL has issued regulatory or class exemptions that cover certain transactions. All class exemptions are cited as “PTE” with the appropriate number, the first two or four digits of which are the year in which the PTE was issued (e.g., PTE 80-26 was issued in 1980; PTE 2000-58 was issued in 2000).

Note about Terminology

The descriptions of the PTs in this section refer to disqualified persons, which is the terminology used in the IRC. For ERISA purposes, simply substitute the term party-in-interest. The parallel ERISA citations are provided. All disqualified persons are parties-in-interest, but not all parties-in-interest are disqualified persons. If a PT involves a disqualified person, the excise tax provisions under IRC §4975 apply and, if the plan is an ERISA-covered plan, an ERISA fiduciary breach has occurred. However, if a PT involves a party-in-interest who is not a

[28] ERISA §3(14)(H).
[29] ERISA §3(14)(I).

disqualified person, the excise tax provisions do not apply to the party-in-interest, but the ERISA fiduciary breach issues are still applicable.

Participant-Directed Accounts Not Exempt from Prohibited Transaction Rules

The PT rules are applicable even if investments are participant-directed. In fact, DOL Reg. §2550.404c-1(e)(3) provides that nothing in ERISA §404(c) offers relief from the applicable excise taxes under IRC §4975 with respect to PTs in the participant-directed account.

Prohibited Transaction Does Not Disqualify a Plan under IRC §401(a)

IRC §401(a), which lists the requirements for qualification under the IRC, does not refer to the PT rules as one of its requirements. Therefore, a qualified plan that engages in a PT does not become a disqualified plan solely by reason of the transaction. The PT rules are enforced through the excise tax provisions of IRC §4975.

However, under certain circumstances, the activities that constitute PTs might result in a violation of the exclusive benefit rule under IRC §401(a)(2), which is a disqualifying event. These circumstances are rare, and the exclusive benefit rule is invoked sparingly by the IRS with respect to PTs.

SALE, EXCHANGE OR LEASING OF PROPERTY

The plan may not sell, exchange or lease property to a disqualified person, nor may a disqualified person sell, exchange or lease property to the plan.[30] This includes direct or indirect transactions. For example, a sale of property by the plan to a third party, where the sale is for the purpose of the third party selling the property to a disqualified person, would be an indirect sale between the plan and the disqualified person. A sale, exchange or lease between the plan and a disqualified person is a PT, even if the sale is for fair market value or the lease is for fair rental value. Fair value, however, will affect the cost of correcting the PT, or, if an exemption is sought, will be necessary to obtain such relief.

A significant aspect of plan operation involves investment trades (i.e., sales and purchases of securities, mutual fund shares, insurance contracts and the like). If an investment trade involves the plan and a disqualified person, PT issues might arise. These transactions, in some cases, raise the appearance of fiduciary self-dealing as well, which is another aspect of PTs that will be discussed below. In addition, there are numerous PT class exemptions that have been issued with respect to investment trading transactions.

EXAMPLE 9-1. Purchase of Property from the Plan by a Disqualified Person. S is an accountant. S prepares Forms 5500 for Corporation X's profit-sharing plan. The Corporation X plan owns a limited partnership interest that the trustees are trying to sell. S agrees to purchase the property. The sale is a PT

[30] IRC §4975(c)(1)(A); ERISA §406(a)(1)(A).

because, as a service provider to the plan, S is a disqualified person. Note that the transaction would be prohibited, even if the plan hires an independent appraiser to value the limited partnership interest and S pays fair market value for the asset.

Contribution of Property

The Supreme Court has ruled, in the case of *Commissioner v. Keystone Consolidated Industries, Inc.*,[31] that a contribution of property (rather than cash) to satisfy a funding obligation is treated as a sale of property to the plan and is a PT. The DOL issued additional guidance on the Keystone decision that provides that all contributions of property to a plan that is subject to minimum funding standards (e.g., money purchase pension, target benefit or defined benefit plan) are PTs.[32]

In a nonpension plan (e.g., profit-sharing or stock bonus plan), the contribution of property is not a PT if the contribution is purely discretionary and the property is unencumbered (i.e., it is not security for a loan). If the property is encumbered, the contribution of the property is treated as a sale, and, thus, as a PT, even if the contribution would not have been prohibited if the property were not encumbered.[33]

Exemptions

There are several statutory exemptions and class exemptions from this PT rule.

Contribution or Acquisition of Employer Securities

An employer may contribute its own securities (i.e., qualifying employer securities) to the plan, or a plan may acquire employer securities from a disqualified person, without engaging in a PT, so long as the requirements of ERISA §408(e) are satisfied.[34] This exemption is discussed further below.

Sale of Employer Securities and Leasing of Employer Real Property

ERISA §§407 and 408(e) contain exemptions for the sale of qualifying employer securities to or from the plan, and the leasing of qualifying employer real property by the plan.

Purchase of Life Insurance or Annuity Contracts by the Plan from a Disqualified Person

Individual life insurance or annuity contracts may be purchased by the plan from the participant or employer.[35]

[31] 508 U.S. 152, 113 S. Ct. 2006, 16 EBC 2121 (1993).
[32] DOL Interpretive Bulletin 94-3, DOL Reg. §2509.94-3.
[33] IRC §4975(f)(3).
[34] IRC §4975(d)(13).
[35] PTE 92-5.

Purchase of Insurance from the Plan

The plan may sell a life insurance policy or individual annuity contract to the participant insured by the policy, to a relative of the insured participant, to the employer or to another employee benefit plan. A relative of the participant includes a spouse, an ancestor (parent, grandparent), a lineal descendant (child, grandchild), a spouse of a lineal descendant (daughter-in-law or son-in-law) or a sibling.

The exemption is not available unless the plan is going to surrender the policy if it is not purchased under the exemption.[36]

LENDING OF PLAN ASSETS OR OTHER EXTENSION OF CREDIT

The plan may not lend money or otherwise extend credit to a disqualified person, nor may a disqualified person loan money or otherwise extend credit to the plan.[37] This includes direct or indirect transactions. Note that a loan between the plan and a disqualified person is a PT, even if the loan is for fair market value.

Identifying Prohibited Loans

The following paragraphs describe various transactions that constitute a loan or extension of credit in contravention of the PT rules, unless an exemption applies. Continuing transactions and loans or extensions of credit can also result in PTs when a plan gets involved in the transaction after its origination date.

Third-Party Loans

If a loan is made by the plan to a third party, but the purpose of the loan is for the third party to lend the money to the employer, an indirect PT exists between the plan and the employer.

Indirect Benefit Derived from Trustee Who Authorizes the Plan Loan

A loan to a partnership in which one of the trustees had a 39 percent partnership interest was ruled to be a PT because it was an indirect loan from the plan to the trustee who was a partner of the borrowing partnership.[38]

Guarantee is an Extension of Credit

If a disqualified person (e.g., employer) guarantees a loan made to the plan, the guarantee is treated as an indirect extension of credit.

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[36] PTE 92-6.
[37] IRC §4975(c)(1)(B); ERISA §406(a)(1)(B).
[38] TAM 9119002.

Participant Loan Exemption Might Be Available

If the disqualified person is a participant in the plan, a loan from the plan might be available through the plan's loan program. In this case, the disqualified person is receiving the loan in his or her capacity as a plan participant, and an exemption is available under IRC §4975(d)(1) and ERISA §408(b)(1) if certain conditions are met.

Failure to Transmit Participant Contributions on a Timely Basis

An indirect loan transaction arises when an employer is delinquent in transmitting participant contributions (including elective contributions (pre-tax elective contributions, catch-up contributions and designated Roth contributions) under a 401(k) arrangement, after-tax employee contributions and participant loan payments deducted from the participant's payroll). The DOL has provided guidelines regarding the deadline for transmitting participant contributions to the trust. When the deadline passes, the contributions are treated as plan assets, regardless of whether the employer has deposited them. If the employer is in possession of plan assets, the employer has effectively borrowed the funds from the plan, which is a PT.[39]

Participant Loan Exemption

Loans to plan participants and beneficiaries are not PTs if the conditions of IRC §4975(d)(1) and ERISA §408(b)(1) are satisfied. Although not all participants and beneficiaries are disqualified persons, all employees are parties-in-interest, so any loan to a participant who is an active employee must satisfy the loan exemption requirements to avoid sanctions under Title I of ERISA.

If You're Curious . . .

Available on a Reasonably Equivalent Basis

The loan must be available to all participants and beneficiaries on a reasonably equivalent basis.[40]

Minimum loan amount. Loans do not fail to be available on a reasonably equivalent basis merely because a minimum loan amount of not more than $1,000 is required by the plan.[41] The minimum loan requirement may be disregarded in determining whether the loans are available on a nondiscriminatory basis.[42]

Limiting loans available to former employees and beneficiaries. The reasonably equivalent rule generally requires that loans also be available to former employees and beneficiaries, as well as to active employees. However, in Advisory Opinion 89-30A, the DOL stated its position that the availability of the loans may be restricted to parties-in-

[39] DOL Reg. §2510.3-102.
[40] DOL Reg. §2550.408b-1(b).
[41] DOL Reg. §2550.408b-1(b)(2).
[42] Treas. Reg. §1.401(a)(4)-4(b)(2)(ii)(E).

interest. That would include all active employees (see the parties-in-interest category under ERISA §3(14)(H)), and only former employees or beneficiaries who satisfy the party-in-interest definition in ERISA §3(14). Former employees or beneficiaries generally are not parties-in-interest unless they are owners, directors or officers of the employer, or have similar relationships with a business substantially-owned by the employer. Merely being a participant (i.e., still having an unpaid vested account balance in the plan) does not make a former employee a party-in-interest.

Related to this issue is a requirement under the IRC §401(a)(4) regulations to test nondiscrimination issues separately for active employees and former employees. If a plan makes loans available to former employees only if they are parties-in-interest, it would be possible that loans would be available to a discriminatory group of former employees. To alleviate this concern, Treas. Reg. §1.401(a)(4)-10 allows the plan, in determining whether its loan program is available on a nondiscriminatory basis, to treat former employees who are parties-in-interest as if they are active employees.

Alternate payees under QDROs are beneficiaries. An alternate payee (e.g., former spouse) under a qualified domestic relations order (QDRO) is a beneficiary for this purpose. If the plan limits loans to parties-in-interest, an alternate payee would not be eligible for a loan unless the alternate payee is a party-in-interest. In some cases, there might be a significant delay between the issuance of a QDRO and the actual payment to the alternate payee. For example, if the participant has not reached his or her earliest retirement age under IRC §414(p)(4)(B), the QDRO cannot require payment to the alternate payee unless the plan permits QDRO distributions before the participant's earliest retirement age. If the loan program is not available to the alternate payee, the alternate payee would not have any means of accessing the funds prior to the time of distribution.

Limitation on loans to officers and directors pursuant to the Sarbanes-Oxley Act. In Field Assistance Bulletin 2003-1 (April 15, 2003), the DOL clarifies its position regarding the administration of participant loan programs in light of the Sarbanes-Oxley Act (SOA). The SOA adds section 13(k) to the Securities Exchange Act of 1934 (1934 Act), which makes it unlawful for any issuer, directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit or to modify or renew an extension of credit maintained by the issuer on the date of enactment, in the form of a personal loan to or for any director or executive officer (or equivalent thereof). There is a question about whether section 13(k) of the 1934 Act prohibits directors and executive officers from taking loans from employee pension benefit plans maintained by the issuer (or a subsidiary of the issuer).

The DOL concluded in this bulletin that a decision to disallow loans based on a reasonable concern over the legality of the loan under the SOA would not be a failure to provide loans to all participants on a reasonably equivalent basis. The DOL does not answer the question about whether the SOA prohibits such loans because it does not have any regulatory authority with respect to section 13(k) of the 1934 Act. This is an issue that the SEC may ultimately decide.

Nondiscriminatory in Amount

Loans may not be available to highly compensated employees, officers or shareholders in amounts greater than they are available to other employees.[43] Loans may be limited to a maximum percentage of the vested account balance (e.g., 50 percent) or to a maximum dollar amount (e.g., $50,000).

Note that plans will generally not permit loans in excess of 50 percent of the vested account balance because of the adequate security requirement (see below).

Required Documentation

Specific loan provisions in the plan, or in a separate written program incorporated by reference into the plan, must address the following items:[44]

• Person(s) authorized to administer loan program;

• A procedure for applying for a loan;

• Limitations (if any) on the amount of loan available or the permitted purposes for the loan;

• Collateral that must be given for a loan;

• The procedure for determining reasonable rate of interest; and

• Events that constitute default.

Reasonable Rate of Interest Must be Charged

The plan must charge a commercially reasonable rate of interest.[45] The interest rate must be commensurate with the interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances.

The Service members Civil Relief Act of 2003 (SCRA) imposes an interest rate limitation on loans made to individuals who, subsequent to the origination of the loan, are called to active military duty. This limitation will supersede the interest rate requirement under the normal PT exemption, because ERISA does not preempt other federal law unless preemption is expressly provided.

The DOL regulations do not establish a safe harbor standard for determining commercially reasonable interest. Most plans administer the reasonable interest requirement by reviewing a sampling of third-party lenders (e.g., commercial banks) and the rates charged for similarly secured loans. Some plans use a formula tied to a commercially recognized benchmark (e.g., 1 percent or 2 percent above prime rate in effect at the beginning of the month), but the DOL will not give an opinion as to whether any particular benchmark is reasonable under the circumstances. Although plans that use this approach generally are not challenged by IRS auditors or DOL examiners, it is the responsibility of the plan administrator (or other fiduciary who is delegated this responsibility) to determine if the interest being charged by the plan satisfies the commercially reasonable standard.

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[43] DOL Reg. §2550.408b-1(c).
[44] DOL Reg. §2550.408b-1(d).
[45] DOL Reg. §2550.408b-1(e).

State usury laws. Limiting the interest rate to applicable state usury laws would not satisfy this requirement if the interest rate charged would otherwise not be commercially reasonable.[46] The DOL has taken the position that ERISA preempts usury laws.

Whereas many commercial loans are subject to certain disclosure requirements (generally called the Truth-in-Lending disclosures or Regulation Z), retirement plan loans are exempt from the disclosure requirements.

Adequate Security Requirement

The loan must be adequately secured.[47]

50 percent limit on security provided through vested account balance. No more than 50 percent of the vested account balance may be considered by the plan as security for the outstanding balance of all plan loans made to the participant. The 50 percent limit is not exceeded if it is satisfied immediately after the origination of each loan, even if the loan later exceeds 50 percent of the vested interest.

Spousal consent. If the plan is subject to the qualified joint and survivor annuity (QJSA) rules, spousal consent must be obtained on the use of any portion of the participant's account balance as collateral.[48] If the plan is not subject to the QJSA rules, the participant may consent to the use of his or her account balance as collateral without obtaining spousal consent.

Protection from Risk of Loss

The responsible fiduciary must consider whether the other participants are reasonably protected from risk of loss. If the loan is secured solely with the participant's vested account balance, this issue may be more significant because of the potential for delay between a default on the loan and the plan's ability to foreclose against the account balance through a loan offset.

Earmarked loans. If loans are held as segregated (or earmarked) investments of the borrowing participant's account under a defined contribution plan, the risk of loss to other participants is eliminated.

Using payroll withholding to keep loans current. If the loan program requires the participant to consent to payroll withholding for repayment of the loan, the risk of loss to other participants is minimized even if the loan is held as a pooled investment for the plan participants.

Excise Tax Applies, Possible Disqualification, If Exemption Requirements Are Not Satisfied

If the exemption requirements discussed above are not satisfied with respect to a participant loan, the loan is treated as a PT and is subject to the excise taxes under IRC §4975.

[46] Example (3) in DOL Reg. §2550.408b-1(e).
[47] DOL Reg. §2550.408b-1(f).
[48] IRC §417(a)(4); ERISA §205(c)(4).

Furthermore, participant loans that use some or all of the account balance as security are exempted from the IRC's prohibition on assignment of account balance only if the loans are not PTs. Therefore, if a participant loan is made that does not satisfy the PT exemption requirements and that loan is secured by the participant's account balance, the plan is in violation of the IRC's antiassignment rule, potentially resulting in plan disqualification.[49]

As will be discussed in Chapter 10, a loan could be treated as a taxable distribution if certain rules in IRC §72(p) are not met. In *Medina v. Commissioner*,[50] the court held that the PT excise taxes apply to a nonexempt loan, even if the loan is treated as a taxable distribution under IRC §72(p).

ESOP Loans

An employee stock ownership plan (ESOP), as defined in IRC §4975(e)(7), may borrow money for the purpose of acquiring employer securities.[51] The employer may make the loan to the ESOP, or the employer may guarantee a loan made to the ESOP from a third party lender.

When a plan finances a purchase with debt, unrelated business taxable income (UBTI) may result because of the debt-financed property rules under IRC §514. However, the IRS has ruled that the exempt loan does not generate UBTI to the ESOP.[52]

Because of the inherent self-dealing issues involved with an ESOP loan, the Treasury and the DOL will scrutinize these transactions. It is recommended that an independent fiduciary approve the loan to ensure that the interests of the plan participants and beneficiaries are being adequately protected.[53]

Class Exemptions Covering Interest-Free Loans to Plan

A disqualified person or party-in-interest may make an interest-free loan to the plan. The loan must be used for the payment of ordinary operating expenses or for a purpose that is incidental to the operation of the plan.[54] A plan is eligible for this exemption if it is an employee benefit plan described in ERISA §3(3) or a plan described in IRC §4975.[55]

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[49] IRC §401(a)(13); Treas. Reg. §1.401(a)-13(d)(2).
[50] 22 EBC 2601, 112 T.C. No. 6 (Tax Ct. 1999).
[51] IRC §4975(d)(3).
[52] Rev. Rul. 79-122, 1979-1 C.B. 204.
[53] Treas. Reg. §54.4975-7(b)(2)(ii) and DOL Reg. §2550.408b-3(b)(2).
[54] PTE 80-26, as modified by PTE 2000-14, PTE 2002-13, and PTE 2002-14.
[55] PTE 2002-13.

If You're Curious . . .

The PT exemption does not describe what types of expenses are incidental to a plan's operation. However, in the preamble to the exemption, the DOL cites two examples of incidental expenses.

1. ***Overdrafts***. There are temporary overdrafts incurred by the trustee in a purchase transaction where cash to cover the purchase might be invested in an investment that cannot be liquidated until the next business day. The employer or trustee might want to cover the overdraft with an interest-free loan, which is for a term of not more than three business days.

2. ***Dividends or interest credit***. A bank trustee credits dividends or interest to a plan on the due date, even though the dividends or interest have not, in fact, been received by the bank. Again, the employer or trustee might want to cover the dividends or interest with a short-term interest-free loan.

The exemption does not define ordinary operating expenses, but does provide that ordinary operating expenses include the payment of benefits and periodic premiums under an insurance or annuity contract. Presumably, regular administrative fees, such as recordkeeping fees and trustee fees, would be included here as well.

Additional conditions. Relief under this exemption is not available unless the interest-free loan meets these additional requirements:

- No interest or other fee may be charged to the plan, and no discount for payment in cash may be relinquished by the plan in connection with the loan or extension of credit.
- The loan to the plan must be unsecured. In other words, the plan may not collateralize the loan with other plan assets.
- The loan may not be made by another employee benefit plan. For example, an employer's defined benefit plan may not make an interest-free loan to the employer's money purchase pension plan.

FURNISHING OF GOODS, SERVICES OR FACILITIES

The plan may not furnish goods, services or facilities to a disqualified person, nor may the disqualified person furnish goods, services or facilities to the plan.[56]

Exemption for Reasonable Compensation for Office Space or Certain Services

Reasonable compensation may be paid for office space or legal, accounting or other services "necessary for the establishment or operation of the plan."[57] It is through this exemption that a

[56] IRC §4975(c)(1)(C); ERISA §406(a)(1)(C).
[57] IRC §4975(d)(2). Additional rules regarding this exemption are provided in Treas. Reg. §54.4975-6 (mirror provisions in DOL Reg. §2550.408b-2).

service provider (e.g., third-party recordkeeper) may receive payment for services directly from plan assets.

The determination of whether compensation is reasonable is one of facts and circumstances. Restrictions applicable to payment of compensation for services are found in Treas. Reg. §54.4975-6(e). Any compensation that would be considered excessive under Treas. Reg. §1.162-7 (relating to compensation for personal services which constitutes an ordinary and necessary trade or business expense) will not be treated as reasonable compensation under these regulations.

Fiduciary Who Is Full-time Employee of Employer

A fiduciary who already receives full-time pay from the employer may not be compensated from the plan except for reimbursement of direct expenses properly and actually incurred.[58] Treas. Reg. §54.4975-6(e)(3) makes clear that this restriction does not apply to a disqualified person who is not a fiduciary, even though IRC §4975(d)(10) would suggest otherwise.

Full-Time Employee May Not Receive Compensation for Acting as Trustee

A full-time employee of the employer who serves as trustee of the plan may not receive compensation for serving as trustee, but may be reimbursed for direct expenses incurred in performing such duties.

The regulations do not define what a direct expense is, but state that a direct expense is not an expense that would have been sustained even if the service had not been provided, or an expense that represents an allocable portion of overhead costs.[59]

No Exemption for Self-Dealing

The exemption for reasonable compensation does not apply to self-dealing transactions under IRC §4975(c)(1)(E) and (F), at least according to the IRS and DOL. The agencies consider that a fiduciary is engaged in an act of self-dealing if he or she uses his or her power as a fiduciary to cause additional compensation to be paid to him or her in a service capacity with respect to the plan.[60]

If a fiduciary is retained by another fiduciary to perform a service for the plan for an additional fee, then a self-dealing violation has not occurred and the fiduciary that is providing the service may rely on the reasonable compensation exemption.[61] Mere approval by another fiduciary is not sufficient to meet this exception, however, if the first service provider fiduciary exercises effective control in the plan's decision to retain him or her to perform the service.

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[58] IRC §4975(d)(10).
[59] Treas. Reg. §54.4975-6(e)(4).
[60] Treas. Reg. §54.4975-6(a)(5)(i) and DOL Reg. §2550.408b-2(e).
[61] Treas. Reg. §54.4975-6(a)(5)(ii).

A self-dealing violation does not occur if the fiduciary provides the service without compensation from the plan, other than reimbursement for direct expenses, as described above.[62]

USE OF PLAN ASSETS BY DISQUALIFIED PERSON

The income or assets of the trust may not be transferred to, or used by or for the benefit of, a disqualified person.[63] In many cases, these transaction limitations overlap with the self-dealing rules, because the disqualified person receiving the benefit is also acting as a fiduciary in the transaction. This type of transaction is fact-specific, meaning that the IRS and DOL will analyze whether, under the circumstances, a personal benefit is being derived by the disqualified person from the transaction involving plan assets. This is a highly subjective analysis.

Payment of Benefits to Participant Who is a Disqualified Person

Payment of benefits to a disqualified person, in his or her capacity as a plan participant or beneficiary, is not a PT.[64]

Loans to Firm's Clients

In Technical Assistance Memorandum (TAM) 9238003, the IRS ruled that loans by a law firm's profit-sharing plan to the firm's clients were PTs. The assets were being used for the benefit of the law firm by allowing clients to receive loans from the plan as an advance for personal injury settlements that would later be obtained for the client by the law firm.

Employer Acting as Agent of Trustee in Making Disbursements

An employer does not engage in a PT when the employer is acting solely as an agent of the plan trustee to pay benefits. Treas. Reg. §35.3405-1, A-16, contemplates the transfer of plan funds to the employer for the sole purpose of having the employer act as payor of the plan distributions for income tax withholding purposes. An employer that receives plan funds as payor-agent of the trustee should deposit such funds into a non-interest-bearing checking account and immediately issue a benefit check to the appropriate participant(s).

Failure to Transmit Participant Contributions on a Timely Basis

An employer has the use of plan assets when it is delinquent in transmitting participant contributions (including elective contributions under a 401(k) arrangement after-tax employee contributions or loan payments). In DOL Reg. §2510.3-102, the DOL prescribes guidelines

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[62] Treas. Reg. §54.4975-6(a)(5)(iii).
[63] IRC §4975(c)(1)(D); ERISA §406(a)(1)(D).
[64] IRC §4975(d)(9).

regarding the deadline for transmitting participant contributions to the trust. When the deadline passes, the contributions are treated as plan assets, regardless of whether the employer has deposited them. If the employer is in possession of plan assets, IRC §4975(c)(1)(D) is violated.

SELF-DEALING BY A FIDUCIARY

A self-dealing PT is one that involves a disqualified person who is a fiduciary. The transaction is prohibited if the fiduciary deals with the income or assets of the plan in his or her own interest,[65] or if the fiduciary receives consideration from another party dealing with the plan in connection with the transaction.[66] Like the use-of-plan-assets transactions described above, the determination of whether a self-dealing transaction has occurred depends upon the facts and circumstances, and is a subjective determination in many cases. The key issue is whether the fiduciary exercises the authority or control that makes that person a fiduciary in a manner that: (1) benefits the fiduciary (or a person in whom the fiduciary has an interest that may affect the fiduciary's best judgment as a fiduciary), or (2) causes the fiduciary to receive consideration from a third party.

Transactions that Might Raise Self-Dealing Issues

There have been numerous court decisions and IRS and DOL rulings dealing with the issue of self-dealing. A fiduciary may be self-dealing by receiving payment directly from the plan in connection with a transaction over which the fiduciary had authority or control. Sometimes the consideration is from a third party, such as a finder's fee, kickback, or other compensation paid by another person involved in the transaction with the plan.

The key to analyzing a potential self-dealing situation is whether the fiduciary had the authority to decide whether the plan entered into the transaction, and by exercising such authority, whether the fiduciary was personally compensated either by the plan or by a third party involved in the transaction, or otherwise benefited personally from the transaction.

Loans Made by Bank Trustee

In *Martin v. National Bank of Alaska*,[67] a bank trustee authorized mortgage loans to be made by a plan to third parties who had taken construction loans from the bank. The mortgage loans were used by those parties to repay the construction loans. The court ruled the trustee was self-dealing because the plan loans were made in the bank's own interest (i.e., to enable the third parties to repay the construction loans). In addition, the origination and servicing fees collected by the bank on the mortgage loans, which were paid by the borrowers directly to the bank, constituted consideration from third parties in connection with the investment of plan assets, another act of self-dealing under IRC §4975(c)(1)(F).

[65] IRC §4975(c)(1)(E); ERISA §406(b)(1).
[66] IRC §4975(c)(1)(F); ERISA §406(b)(3).
[67] 828 F. Supp. 1427 (D.Alaska 1993).

Interim Financing

A similar example of self-dealing arose in *Brock v. Citizens Bank of Clovis*.[68] In that case, the bank trustee made loans from the plan to third parties who had received interim financing from the bank. The proceeds from the loans made by the plan were used to repay the interim financing.

Gratuities Paid to Trustees

In *Secretary of Labor v. Carell*,[69] an administration firm reimbursed the plan trustees for expenses incurred by the trustees' spouses when they attended trustee meetings. The court ruled the payments constituted consideration received by the trustees in connection with plan assets, and constituted self-dealing. Although plan assets were not directly used, the court noted that the gratuities influenced the trustees in their dealings with plan assets. For example, the trustees would be more likely to continue to retain the administration firm to perform services for the plan.

Mere Presence of Independent Fiduciary is Not Enough to Ensure No Self-Dealing

The mere presence of an independent fiduciary acting on the recommendations of a consultant/advisor is not sufficient to insulate the consultant/advisor from fiduciary liability under the self-dealing rules.[70] The keys are:

- The nature of the services being rendered,
- Whether such services cause the person to be acting as a fiduciary, and
- Whether actions in such capacity result in self-dealing.[71]

Commissions and Other Similar Fees

Because the self-dealing rules encompass consideration received by the fiduciary from a third party involved with the transaction, the receipt of commissions and similar fees in common investment transactions raises a self-dealing issue. In some cases, these payments are received directly from plan assets, as well. Even if the person receiving the commissions or fees is not a fiduciary, as a service provider he or she must receive no more than reasonable compensation to avoid a violation under IRC §4975(c)(1)(C). Also, under IRC §4975(c)(1)(D), a disqualified person may not use plan assets for his or her own benefit. With the plan's primary activities being the investment of assets, transactions involving commissions and other similar fees are commonplace.

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[68] 841 F.2d 344 (10th Cir. 1988).
[69] 17 EBC 1159 (M.D. Tenn. 1993).
[70] Advisory Opinions 84-03A and 84-04A.
[71] Advisory Opinions 84-03A and 84-04A.

Purchases of Stock in Bank Trustee's Parent Company

The DOL has opined that a plan's purchase of stock in the bank trustee's parent company would not constitute an act of self-dealing, provided an independent fiduciary directed the transactions, and the purchase was made through an unaffiliated national brokerage firm in a blind transaction.[72]

Recommendation to Trustee to Make Loan to Related Party Not Self-Dealing

In *Greenlee v. Commissioner*,[73] the Tax Court ruled that a fiduciary did not engage in prohibited self-dealing when the fiduciary recommended to the bank trustee that the plan invest in a loan to a corporation in which the fiduciary had an 18 percent ownership interest, even though the bank made the investment. The fiduciary did not exercise his or her authority, control or responsibility to cause the plan to make the investment. The bank trustee retained exclusive discretion over whether the plan would make the investment. The fiduciary's recommendation was merely a suggestion.[74]

Transactions Directed by the Participant

In *Flahertys Arden Bowl, Inc. v. Commissioner*,[75] the IRS treated the participant as a fiduciary for purposes of IRC §4975, because the participant had control over the investment of his account. Because the participant is a fiduciary, a business substantially owned by the participant (Flahertys Arden Bowl) is a disqualified person, so a loan from the participant's account to that business resulted in a PT.

The effect of treating the participant as a fiduciary of his or her account is that the self-dealing provisions of IRC §4975(c) (1)(E) and (F) become applicable to the participant. In addition, the participant is treated as a fiduciary for purposes of determining who is a disqualified person with respect to the plan. If a directed transaction results in self-dealing, then the participant, as the disqualified person engaged in that transaction, would be liable for the applicable excise taxes. In addition, if the participant's status as a fiduciary causes another person to be a disqualified person, transactions between the plan and that person would be PTs, resulting in excise taxes incurred by that disqualified person. There are no adverse consequences to the plan merely because the participant's self-directed account engages in a PT.

Note that the fiduciary responsibility standards of ERISA are not applicable to the participant solely because he or she directs the investment of his or her account. ERISA §404(c)(1)(A) provides that, in the case of a plan that permits a participant or beneficiary to exercise control over assets in his or her account, "such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise." Although ERISA §404(c)(1)(A) protects the participant

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[72] Advisory Opinion 92-23A.
[73] 72 T.C.M. 394 (1996).
[74] Treas. Reg. §54-4975-6(a)(6), Example 3.
[75] 115 T.C. 269 (2000), *affirmed per curiam*, 271 F.3d 763 (8th Cir. 2001).

from fiduciary status merely because of investment direction over his or her account, it does not carry over to the PT provisions of the IRC.

Investments in Insurance Contracts or Mutual Funds by Certain Service Providers

Insurance agents and brokers, pension consultants and mutual fund underwriters are permitted to invest plan assets in insurance contracts or mutual fund shares, and to receive sales commissions, if certain conditions are met.[76]

Purchases or Sales of Securities between Plans and Certain Broker-Dealers, Reporting Dealers and Banks

This exemption allows a plan to engage in a purchase or sale of securities with a broker-dealer, reporting dealer or bank that is a disqualified person or party-in-interest, if certain conditions are satisfied. The exemption also covers extensions of credit between broker-dealers and plans.[77]

Securities Transactions/Pooled Separate Accounts

Fiduciaries (or their affiliates) are allowed to effect or execute securities transactions under certain conditions, and sponsors of pooled separate accounts and other pooled investment funds are permitted to use their affiliates to effect or execute securities transactions, under certain conditions. This exemption provides relief from the self-dealing rules.[78]

Investment in Mutual Funds Managed by Fiduciary

A class exemption allows a fiduciary of a plan (e.g., investment manager for the plan) to invest assets in open-end mutual funds for which the fiduciary is also the investment advisor. There may be no commissions paid in connection with this transaction, and redemption fees are payable only to the investment company and only with full prospectus disclosure. Furthermore, the plan may not pay any investment management, investment advisory or similar fee with respect to plan assets invested in mutual fund shares. However, an investment advisory fee may be paid by the mutual fund in accordance with the terms of its investment advisory agreement. If the plan pays an investment advisory fee that is based on total plan assets, credit must be given for the pro rata share of investment advisory fees paid on such assets by the mutual fund.[79]

A fiduciary that is independent of the investment manager of the mutual fund must approve the investments and receive full disclosure of the fee structure. There are specific circumstances under which a fiduciary is not considered independent.

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[76] PTE 77-9, as amended by PTE 84-24.
[77] PTE 75-1.
[78] PTE 86-128.
[79] PTE 77-4.

In-House Mutual Fund Plan

A mutual fund company that sponsors a plan for its employees is permitted to invest plan assets in its own open-end mutual fund. The plan must cover:

- Only employees of the mutual fund,
- Employees of the mutual fund's investment advisor or principal underwriters, or
- Employees of any affiliate of the investment advisor or principal underwriters.[80]

A different exemption provides relief similar to that noted above for in-house mutual funds. Under this exemption, relief was granted for the acquisition and sale of shares of a registered, closed-end mutual fund by plans covering employees of the mutual fund, its investment advisor or an affiliate of either.[81]

Receipt of 12b-1 and Similar Fees

Rule 12b-1 of the Investment Company Act permits the mutual fund to pay distribution expenses (known as 12b-1 fees). Receipt of 12b-1 fees by a disqualified person or party-in-interest may result in a PT. Fees also might be paid by the mutual fund under a subtransfer agency arrangement (typically a fee for recordkeeping services).

DOL Advisory Opinions Involving 12b-1 Fees

The DOL addresses the 12b-1 fee issue more directly in Advisory Opinion 97-15A and Advisory Opinion 97-16A.[82]

In Advisory Opinion 97-15A, a bank trustee received the 12b-1 fees and subtransfer agency fees. Because the trustee could change the mutual funds available for investment by the plan without the approval of an independent fiduciary, the bank was acting as a fiduciary with respect to the mutual fund investments. In that situation, the DOL concluded that the 12b-1 fees could be received without violating the self-dealing prohibitions under ERISA §406(b) only if full disclosure is made to the plans and the fees offset the plan's obligation to pay the trustee for its services (e.g., trustee fees and recordkeeping fees).

In Advisory Opinion 97-16A, the recipient of the fees was acting solely as a service provider. Although it could delete or substitute funds from the plan's investment program, such changes were subject to advance notice, and the plan fiduciaries could reject such changes without penalty. Therefore, the service provider did not exercise discretionary authority or control, and so was not acting as a fiduciary. As a result, the 12b-1 fees could be accepted without violating the self-dealing prohibitions under ERISA §406(b).

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[80] PTE 77-3.
[81] PTE 79-13.
[82] Reprinted in CCH Pension Plan Guide, ¶19,986N and ¶19,986O.

DOL representatives have noted that, under certain circumstances, failure to disclose fees can result in a service provider being classified as a fiduciary of the plan, by reason of having control over the management of plan assets.

Treatment of 12b-1 Fees as Reimbursement of Expenses

In DOL Advisory Opinion 97-19A, the employer incurred direct expenses in providing services to its plan. The DOL permitted the employer to treat 12b-1 fees received from mutual fund investments held by the plan as reimbursements of those direct expenses. DOL Reg. §2550.408b-2(e)(3) permits reimbursement of a fiduciary's direct expenses without engaging in a PT.

Other Exemptions Relating to Financial Institutions

Bank Deposits Made with Plan Assets

IRC §4975(d)(4) permits the investment of plan assets in the deposits of a bank or similar financial institution (or affiliates of such bank or institution) that is the employer sponsoring the plan, or is a fiduciary of the plan making such investments. The exemption is available only if one of the following two circumstances applies:

1. The plan covers only employees of the bank; or
2. The investment must be expressly authorized in the plan or trust instrument, or a fiduciary independent of the bank must expressly authorize the investment.[83]

Common or Collective Fund, Pooled Investment Accounts

IRC §4975(d)(8) permits a bank or trust company to receive reasonable compensation for the sale or purchase of an interest in its common trust fund, collective trust fund, or pooled investment fund. This exemption also covers similar transactions involving the pooled investment fund of an insurance company. The transaction must be expressly permitted by the trust, or by an independent fiduciary with authority to manage and control the assets of the plan. IRC §4975(d)(8) covers self-dealing transactions, which the normal reasonable compensation exemption [IRC §4975(d) (2)] does not.

Insurance Products

IRC §4975(d)(5) permits a plan to invest in life insurance, health insurance or annuities with an insurer that is the employer maintaining the plan or is a disqualified person with respect to the plan. The plan must pay no more than adequate consideration for the contract or policy. If the insurer is a disqualified person (other than the employer maintaining the plan), the total premiums and annuity considerations written by such insurer in a particular year for contracts for all plans, with respect to which it is a disqualified person, must not exceed 5 percent of the total premiums and annuity consideration written by the insurer for all lines of insurance for that year.

[83] Treas. Reg. §54.4975-6(b).

Insurance Companies Related to the Employer

Similar relief is provided to insurance companies that sell insurance contracts to a plan for which the insurance company is a disqualified person or party-in-interest because of its stock or partnership affiliation with the employer maintaining the plan.[84]

Sales by Agents or Brokers Who Are Employers

An insurance agent or broker may sell insurance or annuity contracts to a plan, and receive a commission on such sale, if the transactions satisfies certain conditions. These conditions are:

- The plan must pay no more than adequate consideration for the contracts;
- The total commissions received in each taxable year of the agent or broker as a result of effecting such transactions does not exceed 5% of the total insurance commission income received by such agent or broker in that taxable year; and
- The agent or broker is:[85]
- An employer whose employees are covered by the plan;
- A 10 percent or more partner of such an employer;
- An employee, officer, director or 10 percent or more shareholder of such an employer; or
- A disqualified person or party-in-interest by reason of a relationship to such employer, which is described in IRC §4975(e)(2)(E), or (G), or ERISA §3(14)(E) or (G) (which relate to common ownership or control).

Advising Participants about Investments

If a fiduciary advises participants about investments, and that advice can result in additional compensation to the fiduciary (e.g., recommendations that include investment in the fiduciary's mutual funds), a self-dealing issue arises. The DOL has addressed these situations in some rulings where it has determined that the institution providing the advice is not self-dealing if the advice is structured in a way that protects the interests of the plan participants. Furthermore, the Pension Protection Act of 2006 (PPA) contains certain exemptions from the PT rules for entities that provide investment advice to plan participants under an eligible investment advice arrangement with the plan.[86] The PPA also provides for some relief for the normal plan fiduciaries from liability for the specific advice given under such arrangements, assuming that the investment advisor was prudently chosen and monitored.[87]

Benefiting a Person Related to Fiduciary

A self-dealing violation can arise where the fiduciary uses plan assets to benefit a person in whom the fiduciary has an interest (e.g., a family member), even if the direct transaction with that person qualifies for a PT exemption.

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[84] PTE 79-41.
[85] PTE 79-60.
[86] PPA §601, adding IRC §§4975(d)(17) and 4975(f)(8) and ERISA §§408(b)(14) and 408(g).
[87] ERISA §408(g)(10).

EXAMPLE 9-2. Self-Dealing by Family Member. F, a fiduciary of Plan P with discretionary authority over the management of Plan P, retains S, the son of F, to provide various kinds of administrative services necessary for the operation of the plan for a fee. F has engaged in self-dealing, because S is a person in whom F has an interest which may affect the exercise of F's best judgment as a fiduciary. Such an act is not exempt under IRC §4975(d)(2), regardless of whether the provision of the services by S is exempt.[88]

If the relative is engaged to execute investment transactions for which a commission or other fee is paid, this same self-dealing issue arises. The fiduciary who is related to the service provider must not exercise any control over the decision to retain his or her relative. In some cases, class exemptions may provide relief from the PT rules, where the relative is an affiliate of a person who is covered by the transaction. Also, if the transactions are executed without compensation, the self-dealing issue would generally be avoided.[89]

Serving in Dual Capacities

A disqualified person may serve as a fiduciary even though he or she is an officer, employee, agent or other representative of a disqualified person.[90]

9.05: Class Exemptions and Administrative Exemptions

The DOL may grant an individual exemption from the PT rules if a statutory exemption is not available. The IRS has the authority to grant exemptive relief only for transactions not covered by ERISA, such as exemptions covering IRAs and participant-directed qualified plan accounts.

ADMINISTRATIVE EXEMPTION

Conditions

To grant an exemption, the responsible agency must determine the transaction is:

- Administratively feasible;
- In the interests of the plan, the participants and the beneficiaries as a whole; and
- Protective of the rights of participants and beneficiaries.[91]

[88] Treas. Reg. §54.4975-6(a)(6), Example (6).
[89] Treas. Reg. §54.4975-6(a)(5)(iii).
[90] IRC §4975(d)(11).
[91] IRC §4975(c)(2) and ERISA §408(a).

Acceleration of Certain Approvals (PTE 96-62)

Administrative exemptions can be a time-consuming process. In some cases, the length of time needed to obtain the exemption may compromise the benefits of the transaction to the plan. PTE 96-62 accelerates the approval process if similar transactions have been granted an exemption. The time frames could result in approval in as little as 75 days.

CLASS EXEMPTIONS

If the transaction would have broad application to numerous transactions conducted between plans and disqualified persons/parties-in-interest, the DOL may issue a class exemption. If the terms of the class exemption are satisfied, no administrative exemption application is required. The class exemptions provide relief from both the fiduciary liability consequences under ERISA and the excise tax consequences under the IRC.

Some other types of class exemptions are outlined below.

Certain Transactions Authorized by Court or DOL

There are circumstances under which transactions will be authorized by the courts, or by the DOL or IRS, to remedy a violation of ERISA. These transactions might be PTs without any exemptive relief.[92]

Court-Ordered Transactions

Any transaction that is authorized or required, prior to the occurrence of such transaction, by an order of a U.S. District Court or by a settlement of litigation approved by such court, is exempted from the PT rules.[93] The DOL or IRS must be a party to the litigation at the time of such order or settlement.

Settlement of DOL Investigation

A transaction that is authorized, prior to the occurrence of such transaction, by a settlement agreement resulting from an investigation of the plan by the DOL, is exempt from the PT rules. The DOL must be a party to the settlement agreement.[94]

Insurance Company's General Account

In *John Hancock Mutual Life Insurance Co. v. Harris Trust & Savings Bank,*[95] the Supreme Court ruled that funds allocated to an insurance company's general account that vary with the investment experience of the insurance company are plan assets under ERISA. Therefore, certain transactions between the general account and parties-in-interest of the investing plans may be PTs. Broad exemptive relief is granted in PTE 95-60 for certain transactions involving the general account. Furthermore, pursuant to Congress's direction in the Small Business Job

[92] PTEs 79-15 and 94-71.
[93] PTE 79-15.
[94] PTE 94-71.
[95] 114 S. Ct. 517 (1993).

Protection Act of 1996, the DOL issued regulations on the issue of when underlying assets of an insurer are treated as plan assets.[96]

9.06: Correction of Prohibited Transactions

The Treasury has not issued regulations on the correction of PTs described in IRC §4975. However, similar rules are provided in IRC §4941 for private foundations, and regulations have been issued under those rules. Until IRC §4975 regulations are issued, the Treasury applies the private foundation regulations to determine whether the transaction is properly corrected.[97] The objective for correction is to undo the transaction to the extent possible, but in no case to cause the plan to be in a worse financial position than it would have been if the highest fiduciary standards had been followed.

To determine the proper method of correction for a prohibited use of property for the benefit of a disqualified person or a self-dealing transaction by a fiduciary, the facts and circumstances have to be analyzed. In many cases, these transactions will be most analogous to a loan or lease of property to the disqualified person or fiduciary.

Note that the IRS' resolution programs (under the Employee Plans Compliance Resolution System (EPCRS) umbrella) are not available to correct PTs, and those programs are not available for reducing the excise tax under IRC §4975. EPCRS is available only for qualification defects. A PT, in and of itself, is not a qualification issue. However, the IRS is reportedly exploring the possibility of offering a voluntary correction program for PTs that would result in a reduction or waiver of the excise taxes.

The DOL's Voluntary Fiduciary Correction (VFC) Program is available to relieve a responsible fiduciary from investigation and the ERISA §502(l) penalty relating to his or her enablement of a PT. The VFC Program offers corrective guidance required as a condition for fiduciary relief. Although the corrective guidance in the VFC Program coordinates with the Treasury's correction guidance provided in this section, to the extent the Treasury's guidance would require additional correction, that additional correction would need to be made in order to avoid the second tier excise tax under IRC §4975(b). However, the IRS has informed the DOL that, except where tax abuse is involved, a correction of a PT under VFC generally will be considered a correction for IRC §4975 purposes, as well. In addition, PTE 2002-51 grants relief from excise taxes arising from certain PTs that are corrected under VFC.

CORRECTING A SALE TO THE DISQUALIFIED PERSON

If the plan has sold property to the disqualified person, undoing the transaction includes rescinding the sale whenever possible. The corrective action outlined by the regulations usually

[96] DOL Reg. §2550.401c-1.
[97] Treas. Reg. §§141.4975-13 and 53.4941(e)-1.

involves a transaction between the plan and the disqualified person (e.g., rescission of a sale). However, this does not create a new PT.[98]

CORRECTING A SALE TO THE PLAN

If the disqualified person has sold property to the plan, undoing the transaction includes rescinding the sale whenever possible.[99]

LOAN OR LEASE TO DISQUALIFIED PERSON; LOAN OR LEASE TO PLAN

If the plan lends money or leases property to a disqualified person, or a disqualified person lends money or leases property to a plan, correction includes termination of the loan or lease.[100]

Amount Paid to Plan

In addition to termination of the loan or lease, the following corrective steps must be taken:

- Payment to the plan of the difference between the fair market value of the use of the property (e.g., fair rental value or fair interest rate) over the amount paid for the loan or lease.
- Payment to the plan of the difference between the amount that would have been paid by the disqualified person for the remaining term of the loan or lease, had the transaction not been terminated, over fair market value for such use. Fair market value is determined at the time of correction.

Repayment in Form of Property is Separate Prohibited Transaction

When correcting a prohibited loan, the repayments due to the plan must be in cash to avoid a separate PT from occurring.

EXCESS COMPENSATION

If the transaction would qualify for an exemption under IRC §4975(d)(2) or IRC §4975(d)(10) relating to compensation for certain services, except that the compensation paid is excessive, the correction is made by having the disqualified person return the excess compensation to the plan. A reasonable adjustment for earnings that the plan lost with respect to the payment of the excess

[98] Treas. Reg. §53.4941(e)-1(c)(2). See, e.g., the preamble to a proposed class exemption, 68 F.R. 6954 (February 11, 2002).
[99] Treas. Reg. §53.4941(e)-1(c)(3).
[100] Treas. Reg. §53.4941(e)-1(c)(4) & (5).

compensation should also be included, although the regulation does not make reference to such an adjustment.[101]

LATE DEPOSIT OF EMPLOYEE CONTRIBUTIONS AND PARTICIPANT LOAN PAYMENTS

If the employer does not deposit pre-tax elective contributions, designated Roth contributions, catch-up contributions, after-tax employee contributions or participant loan payments to the trust on a timely basis, the IRS and the DOL consider the amounts to be a PT loan from the plan to the company. Correction of this PT requires the employer to pay to the plan an amount equal to reasonable interest for the period of time between when the deposit should have occurred and when it actually occurred. The interest must be reasonable–that is, it must be what would have been charged for a commercially reasonable loan under similar circumstances. Furthermore, the transaction is subject to the IRC §4975 excise tax discussed below.

Failure to Enroll a Participant into a 401(k) Plan or Failure to Effectuate a Deferral Election

Although the failure to enroll eligible participants or to effectuate a deferral election is not a PT, the following are common 401(k) plan errors for which the IRS has outlined corrections.

Failure to Enroll a Participant in a 401(k) Plan

In its revenue procedure related to the correction of plan errors, the IRS discusses the fact that failing to enroll a 401(k) participant results in the individual being denied the opportunity to make a pre-tax elective contribution or after-tax employee contribution that would have benefitted from tax-deferred growth in the future. Therefore, notwithstanding that the dollars that should have been deferred were given directly to the participant, the participant has still suffered a loss that must be recompensed as part of the correction process.[102]

The IRS procedure[103] defines the "missed deferral" for an excluded participant to be equal to his or her compensation, multiplied by the actual deferral percentage (ADP) for the group (i.e., HCE or NHCE) to which the participant belongs for the year of exclusion, not to exceed the limit on maximum deferrals under IRC §402(g) ($19,500 for 2020). The employer must then deposit to the plan a qualified nonelective contribution (QNEC) in an amount equal to half of the missed deferral, which is referred to as the participant's "missed deferral opportunity." The missed deferral opportunity QNEC is then adjusted for earnings to the date on which the QNEC is deposited.

If the participant would have also been eligible to receive a matching contribution had he or she been enrolled properly, the correction must also include making the participant whole for this

[101] Treas. Reg. §53.4941(e)-1(c)(6).
[102] Rev. Proc. 2019-19, §6.02(7).
[103] Rev. Proc. 2019-19, Appendix A, §.05.

part of the plan. The employer must make a non-elective contribution equal to the matching contribution the participant would have received had he or she contributed the entire missed deferral (i.e., 100 percent of the ADP rate times the participant's compensation) as a salary deferral. This nonelective contribution must also be adjusted for earnings.

EXAMPLE 9-3. Correction of Failure to Enroll an Eligible Participant. XYZ Corporation sponsors a 401(k) plan that operates on a calendar plan year, and matches salary deferrals at the rate of 25 percent. M became eligible to enter the XYZ Plan as of the first day of the 2020 plan year, January 1, 2020. However, the plan administrator overlooked M until he or she was performing the ADP test for the Plan in 2021.

M's compensation for the 2020 plan year was $35,000. The plan administrator determined the ADP rate for NHCEs (not including M) to be 3.15%.

M's missed deferral is the product of the ADP for the NHCEs, multiplied by M's compensation for the year: .0315 x $35,000 = $1,102.50. XYZ Corporation must deposit a QNEC for M equal to M's missed deferral opportunity, or 50 percent of the missed deferral, $551.25, plus earnings. Furthermore, had M elected a deferral equal to the missed deferral, M would have received a matching contribution equal to $275.63 ($1,102.50 x .25). This amount, plus earnings, must also be paid by XYZ Corporation to the Plan in the form of a QNEC on M's behalf. Therefore, the total corrective contribution for M is $826.88 ($551.25 + $275.63), plus earnings.

Other IRS safe harbor correction methods may be acceptable to fix this mistake. For failures found and fixed promptly, plan sponsors have the option to reduce the corrective QNEC contribution for the lost opportunity cost from 50 percent of the missed deferral to 25 percent under the following conditions:

- The excluded employee must be currently employed by the employer at the time of correction
- The period of failure exceeds three months
- Correct deferrals finally begin by the first payment of compensation made on or after the earlier of: o The last day of the second plan year after the plan year in which the failure first began for the affected employee, or the last day of the month after the month the affected eligible employee first notified the plan sponsor; and
- Within 45 days of being given the opportunity to make salary reduction contributions (or the commencement of auto-enrollment contributions), the affected participant must receive a special notice. See Appendix A.05(9) discussed in Rev. Proc. 2019-19 for details as to the specific content that must be in this notice. If the participant terminates employment before the notice is provided, then this requirement has not been met.

If the period of failure is less than three months, no corrective QNEC for the missed deferral opportunity is required. The excluded employee must begin to participate and if the plan provided for auto-enrollment, the commencement of deferrals occurs within the three-month period beginning from the start of the failure and the issuance of the special notice occurs within the 45-day timeframe.

All other corrective contributions must be paid to the 401(k) plan before the end of the second plan year beginning after the initial year of the failure.

For 401(k) plans with automatic contribution features (i.e., auto-enrollment and auto-escalation), the corrective QNEC contribution for the missed deferral opportunity is reduced to zero if correct deferrals begin by the first payment of compensation made on or after the earlier of:

- 9 1/2 months after the end of the plan year in which the failure first occurred, or
- the last day of the month after the month the affected employee first notified the plan sponsor of the error.

The special notice to the affected employee must be provided within the applicable 45-day timeframe. See Appendix A.05(8) discussed in Rev. Proc. 2019-19 for additional details. This special 0 percent rule only applies to failures occurring before 2021. The plan sponsor is still responsible for providing correcting matching contributions or missed employer contributions to the 401(k) plan within the two-year timeframe used to correct significant operational failures under Rev. Proc. 2019-19.

If the plan is a safe harbor plan using the 3 percent nonelective contribution as the safe harbor contribution, the missed deferral is deemed to equal 3 percent of compensation. If the safe harbor plan uses the matching contribution to meet the required safe harbor, the missed deferral is the greater of 3 percent of compensation, or the maximum deferral percentage that would give the participant a matching contribution rate that is at least as favorable as 100 percent of the employee’s elective deferral. The required QNEC would then be equal to 50 percent of that missed deferral, plus the matching contribution (based on the full missed deferral) and/or the 3 percent nonelective contribution provided under the plan, plus earnings.

EXAMPLE 9-4. Correction of Failure to Enroll an Eligible Participants in a Safe Harbor Plan. Suppose that XYZ Corporation (from Example 9-3) sponsors a safe harbor 401(k) plan that provides for a safe harbor matching contribution equal to 100 percent of deferrals up to 3 percent of compensation, and 50 percent of deferrals that exceed 3 percent but not 5 percent of compensation. M is improperly excluded from the Plan during 2020. M’s compensation for the 2020 plan year was $35,000.

Because the highest rate of deferral that is matched 100 percent is 3 percent of compensation, M’s missed deferral is 3 percent of M’s compensation for the year: .03 x $35,000 = $1,050. XYZ Corporation must deposit a QNEC for M equal to M’s missed deferral opportunity, or 50 percent of the missed deferral, $525, plus earnings. Furthermore, M is entitled to a matching contribution equal to 100 percent of M’s missed deferral, or $1,050. This amount, plus earnings, must also be paid by XYZ Corporation to the Plan in the form of a QNEC on M’s behalf. Therefore, the total corrective contribution for M is $1,575 ($525 + $1,050), plus earnings.

> Note that, had the XYZ Plan provided an enhanced match equal to 100 percent of deferrals up to 4 percent of compensation, the missed deferral would equal 4 percent of M's compensation, $1,400, increasing M's missed deferral opportunity to $700 and M's corrective match to $1,400, for a total correction of $2,100, plus earnings. This is because the missed deferral is equal to the greater of 3 percent or the highest rate of deferral that is matched at 100 percent.

The IRS procedure also provides for corrections related to the missed opportunities to make after-tax employee contributions, designated Roth contributions and catch-up contributions.

Partial Year Exclusion

If the plan administrator discovers a failure to enroll error during a plan year, he or she may enroll the participant for the remaining portion of the year. In that situation, the QNEC equal to the missed deferral opportunity is calculated only with regard to compensation earned prior to the time that the participant was enrolled. This correction is reduced if, when added to the actual deferrals made by the participant during the year, the missed deferral would exceed the §402(g) limitation for the year.

If the participant is excluded for a short time–three months or less–before enrollment occurs, the employer need not make any QNEC for missed deferral opportunity, as the IRS believes that nine or more months is sufficient time in which the participant may defer what he or she wants to put into the plan for the year. However, the corrective contribution, in relation to the matching contribution on the missed deferral, must still be made for the excluded period.

Failure to Effectuate a Deferral Election

What if a participant makes a deferral election, but the plan administrator fails to do what is necessary to put the election into effect? The correction is basically the same as for an improper exclusion of an eligible participant, but the missed deferral is equal to the rate of deferral elected by the participant, as opposed to the ADP of the relevant group. If the participant's election is in the form of a dollar amount, the missed deferral is equal to a pro-rata share of the dollar amount for the period during which the election was not put into effect.

9.07: Calculation of Excise Tax on a Prohibited Transaction

The calculation of the excise taxes under IRC §4975 depends on the length of the taxable period and whether the transaction has been corrected. Any excise tax due under IRC §4975 is transmitted with Form 5330. The disqualified person is liable for the tax.

Form 5330 is due by the last day of the 7th month following the *disqualified person's* taxable year for which the tax is being paid. An extension of up to 2½ months can be obtained by filing Form 5558. The extension does not extend the time for paying the excise tax, so interest is charged if the tax is paid after the regular due date.

If a plan official obtains relief under the DOL's VFC Program for certain PTs, the excise tax is automatically waived if certain additional conditions, prescribed by PTE 2002-51, are satisfied.

TAXABLE PERIOD

The taxable period begins on the date of the transaction and ends on the first of the following dates to occur:

- The date the IRS issues a notice of deficiency for the excise tax;
- The date the tax is assessed; or
- The date the transaction is corrected.[104]

Because the taxable period ends on the earliest of the above dates, correction of the transaction or voluntary payment of the tax will reduce the tax liability.

The Tax Court has ruled that settlement with the DOL on fiduciary issues relating to PTs does not preclude the IRS from assessing penalties under IRC §4975.[105] IRC §4975(h) provides that, before the IRS sends a notice of deficiency on either the first-tier tax or the second-tier tax (both of which are described below), the IRS must notify the DOL of the PT. The purpose of the notice is to provide the DOL with a reasonable opportunity to obtain correction of the PT, or to comment on the imposition of the tax.

CALCULATION OF THE INITIAL TAX (FIRST TIER)

The **initial tax** is 15 percent, multiplied by the amount involved for each year (or part of a year) that is included in the taxable period. The year used here is the tax year of the disqualified person. For example, if the disqualified person is an individual, the year is usually the calendar year, because most individuals report income on a calendar year basis. If the disqualified person is a corporation, the year is the corporation's fiscal year on which it reports its tax liability.

Definition of Amount Involved

The determination of the amount involved depends on the type of transaction.[106] They are:

- **Sale Transaction**. In the case of a sale of property, the amount involved is the greater of the fair market value of the property, or the amount paid for the property. Fair market value is determined as of the time the transaction occurred.
- **Unreasonable Compensation Transaction**. In the case of unreasonable compensation that causes a transaction to fail the exemption requirements under IRC §4975(d)(2) or (10), the amount involved is the excess compensation paid by the plan. Note that the IRS has informally indicated that a failure of a service provider to comply with the DOL's fee disclosure regulations under ERISA §408(b)(2), which causes the services contract to be a PT, results in all compensation paid to the provider being considered unreasonable.

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[104] IRC §4975(f)(2).
[105] *Baizer v. Commissioner*, 2000-1 U.S.T.C. ¶50,249 (9th Cir. 2000).
[106] IRC §4975(f)(5).

- **Loan or Lease Transaction**. In the case of a loan, the amount involved is the greater of the fair market interest rate or the interest paid for the use of the money. Similarly, in the case of a lease, the amount involved is the greater of the fair market rental value or the rent paid for the use of the property. Note that the amount involved is not the principal amount of the loan or the fair market value of the property being leased. Fair market rental value or fair market interest value is determined as of the time the transaction occurred. The amount paid means the amount actually paid by the disqualified person, not the amount being charged under the loan or lease.[107]

Tax Calculation for Sale Transaction

For a sale, the excise tax is calculated by multiplying the amount involved by 15 percent. A 15 percent excise tax, as so calculated, is paid for each year (or part of a year) included within the taxable period.[108] Thus, if there is only one taxable year included within the taxable period, the total excise tax is 15 percent of the amount involved. However, if the taxable period spans multiple taxable years, the actual excise tax is 15 percent of the amount involved, multiplied by the number of such taxable years.

EXAMPLE 9-5. Transaction Corrected Within Same Taxable Year. On July 1, an employer sells property to the profit-sharing plan it maintains. The fair market value of the property is $80,000 and the plan pays $80,000 for the property. The amount involved is $80,000 because the fair market value is the amount paid by the plan. If the plan had paid more than fair market value, the amount paid would be used to calculate the amount involved. The sale is rescinded on December 1 of the same year. The employer's tax year is the calendar year. There is only one tax year in the taxable period (July 1 through December 1). The initial excise tax is 15 percent × $80,000, or $12,000.

The transaction is still prohibited, even though the plan paid fair market value, unless an administrative exemption is obtained. If the plan had paid less than fair market value, the fair market value would be used to calculate the amount involved.

EXAMPLE 9-6. Transaction Not Corrected, But Excise Tax Paid. Suppose, in Example 9-5, that the transaction is not corrected, but the employer pays the tax for the year with a timely filing of Form 5330. Payment of the tax ends the taxable period and the initial excise tax is the same as in Example 9-5. However, in this example, the transaction remains uncorrected, exposing the disqualified person to the second tier tax (which will be discussed below).

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[107] *Medina v. Commissioner*, 22 EBC 2601, 112 T.C. No. 6 (Tax Ct. 1999).
[108] IRC §4975(a).

EXAMPLE 9-7. Transaction Corrected in Year Following the Year of the Transaction (Two Years Included in the Taxable Period). Suppose, in Example 9-5, that the transaction is not corrected until the following February, and no excise tax is paid. In this case, there are two tax years (actually two portions of a tax year) included in the taxable period (July 1 through February 1). The excise tax due is 15 percent for each year in the taxable period, for a total of 30 percent × $80,000, or $24,000.

The applicable excise tax rate on a sale is established as of the date of the sale, even if there are multiple tax years included in the taxable period. This is because the sale constitutes a single transaction for excise tax purposes, regardless of the number of years in the taxable period. This principle can affect the rate of tax when there is a statutory change in the rate.

Tax on Unreasonable Compensation Transaction

Presumably, the same calculations apply to unreasonable compensation transactions, although the amount involved in such a transaction is the excess compensation (or, in the case of a disclosure failure by a service provider, presumably the total compensation paid), not the fair market value of the use of the money.

Tax on Loan or Lease Transaction

A loan or lease is a continuing transaction. As such, the IRS treats each year that the loan or lease continues as giving rise to a new transaction.[109] The excise tax is calculated separately for each new transaction. This calculation method results in a pyramiding of excise taxes, because some taxable years may be included in the taxable period of more than one loan, resulting in a separate excise tax on each such loan with respect to that taxable year.[110] Furthermore, the amount involved in the PT when a loan is involved is the interest on the loan. Therefore, the 15 percent excise tax will be charged against the loan interest, not the amount of the loan itself. Similarly, for leases, the amount involved is the lease amount, not the total value of the lease or the property being leased.

EXAMPLE 9-8. Excise Tax on Loan Transaction. A qualified plan lends money to an individual who provides administrative services to the plan. The individual receiving the loan is a disqualified person.[111] The interest rate paid for the loan is 10 percent, which is equal to or greater than the fair market interest rate. The loan is made on April 1, 2016 in the amount of $100,000. The loan is corrected on June 30, 2020. During the term of the loan, only interest payments are made on the loan. The disqualified person's tax year is the calendar year. The IRS treats this as three separate transactions. The first transaction arises on April 1, 2018, the second arises on January 1, 2019 (i.e., the first day of the next tax

[109] Rev. Rul. 2002-43, GCM 38846, instructions to Form 5330.
[110] *Rutland v. Commissioner*, 89 T.C. 1137 (1987).
[111] IRC §4975(e)(2)(B).

year of the disqualified person), and the third arises on January 1, 2020 (i.e., the first day of the second following tax year of the disqualified person). We will refer to these three loan transactions with reference to the year in which each occurred (or was deemed to have occurred): the 2018 transaction, the 2019 transaction and the 2020 transaction.

In this example, note that the rate being charged was 10 percent, which is at least equal to fair market value. However, there is still a PT, unless a statutory or class exemption exists, or an administrative exemption has been obtained. The only significance of the actual rate charged for excise tax purposes is that, if it is greater than fair market value, the amount involved is calculated on the basis of the rate charged, rather than the fair market interest rate. If this loan had been made for below market value, the fair market interest rate would still be used to calculate excise taxes.

Calculation of Tax for the 2018 Transaction. On the Form 5330 that will be filed for 2018, the amount involved is the fair interest rate for 2018. This is a 10 percent annual interest rate on $100,000, prorated for nine months, because the amount was lent for only nine months in 2018. The amount involved is 10% × $100,000 x 9/12, or $7,500. The taxable period is April 1, 2018 (i.e., the date the transaction arose) to December 31, 2018 (i.e., the earlier of the end of the plan year or the date the transaction was corrected). The excise tax is 15% × $7,500, or $1,125. This is the amount due on the 2018 Form 5330.

Calculation of Tax for the 2019 Transaction. The amount involved for 2019 is two-fold: the interest for 2018 (because the transaction is yet to be corrected), and the interest for 2019 (determined as of January 1, 2019). The interest rate for 2018 is the same as was calculated above, $7,500. The interest rate for 2019is a 10 percent annual rate on $100,000, which is the outstanding principal on January 1, 2019, for a period of 12 months. Therefore, this amount involved is 10% x $100,000, or $10,000. The total amount involved is, therefore, $17,500. The taxable period is January 1, 2019 (i.e., the date the new transaction arose) to December 31, 2019 (i.e., the earlier of the last day of the plan year or the date the transaction was corrected). The excise tax is 15% × $17,500, or $2,625. This is paid on the 2018 Form 5330.

Calculation of Tax for the 2020 Transaction. The amount involved for 2020 is three-fold: the interest from 2018 ($7,500), the interest from 2019 ($10,000), and the fair interest rate for 2020 (determined as of January 1, 2020). The interest rate for 2020 is a 10 percent annual rate on $100,000, which is the outstanding principal on January 1, 2020, prorated for six months, because the amount was lent for the period of January 1 through June 30 during 2020. The amount involved is 10% x $100,000 × 6/12, or $5,000. Therefore, the total amount involved is $22,500 ($7,500 + $10,000 + $5,000). The taxable period is January 1, 2020 (i.e., the date the new transaction arose) to June 30, 2020 (i.e., the earlier of the last day of the plan year, or the date the transaction was corrected). The excise tax is 15% × $22,500, or $3,375. This is paid on the 2020 Form 5330.

Recap of Excise Taxes. The following is a recap of the excise tax calculation.

Taxable Year	2016 Form 5330	2017 Form 5330	2018 Form 5330
2018	\$7,500 × 15% = \$1,125	\$7,500 × 15% = \$1,125	\$7,500 × 15% = \$1,125
2019	N/A	\$10,000 × 15% = \$1,125	\$10,000 × 15% = \$1,500
2020	N/A	N/A	\$5,000 × 15% = \$750
Subtotals	\$1,125	\$2,625	\$3,375

Total for all three transactions: \$1,125 + \$2,625 + \$3,375 = \$7,125

Calculation of the Amount Involved in a Prohibited Loan or Lease Transaction

Before determining the applicable excise tax, the amount involved has to be calculated for each loan transaction. As noted above, the amount involved with respect to a loan is the value of the use of the money (not the outstanding principal of the loan) from the date of the loan to the end of the taxable year in which that loan occurs.

Amount Involved for Each Loan or Lease Transaction Reflects No More Than 12 Months of Interest or Rent

The interest for each loan transaction is calculated only for the taxable year in which the loan occurs (or is deemed to have occurred), and only for the portion of the taxable year during which the loan is in effect. Similarly, rent for each rental transaction is calculated only for the taxable year in which the lease occurs (or is deemed to have occurred), and only for the portion of the taxable year that the lease is in effect for such year. This is because a new loan or a new lease is deemed to occur as of the first day of each taxable year. Thus, there will be no more than 12 months of interest or rent calculated for each transaction to arrive at the amount involved for that transaction.

Determining the Principal on Which Interest is Calculated for Each Loan

The principal used to calculate the amount involved on a loan is the outstanding principal as of the date of the loan transaction. Because a new loan is deemed to occur on the first day of each taxable year, the principal must be recalculated as of the date of each new loan. In Example 9-8 above, the outstanding principal is determined as of April 1, 2018, January 1, 2019, and January 1, 2020, respectively, for the 2018, 2019, and 2020 loans.

Effect of Repayment of Portion of Principal

If the principal on the loan is being repaid periodically, the outstanding principal on the date of each new loan transaction will actually decrease from the amount assumed for the prior year's loan transaction. If, in Example 9-8, the outstanding principal balance on January 1, 2019, had been reduced to $75,000 because of loan payments, the calculation would be based on the interest relating to that reduced balance for the Form 5330 for 2019 and 2020.[112]

Application of IRC §72(p) To a Loan has No Effect on Application of Excise Tax

In *Medina v. Commissioner*,[113] a loan made to a participant failed to satisfy the exemption requirements of IRC §4975(d)(1), resulting in the levying of excise taxes on the participant who was a disqualified person with respect to the plan. The court held that the PT excise taxes apply to a loan even if the loan is treated as a taxable distribution under IRC §72(p).

Applicable Excise Tax Rate Established as Date of Each New Loan/Lease

The applicable excise tax rate on a loan or lease is established as of the date of each new loan or lease.[114]

Compare the result above with the one for a sale transaction. A sale transaction is a single PT, so a new sale is not deemed to occur at the beginning of each taxable year, as with a loan or lease transaction. Thus, the applicable excise tax rate is established as of the date of the sale, even if the taxable period for computing the excise tax spans more than one taxable year.

Treatment of Use of Property or Self-Dealing Transactions

For purposes of the excise tax provisions, a prohibited use of property for the benefit of a disqualified person as described in IRC §4975(c)(1)(D), or a self-dealing transaction by a fiduciary as described in IRC §4975(c)(1)(E) or (F), will need to be characterized as either a sale or as a loan or lease, to determine the appropriate excise taxes. The facts and circumstances of the transaction must be analyzed to determine how to categorize the transaction. Where the transaction is an ongoing one, which is typical in a use of property transaction described in IRC §4975(c)(1)(D) and in many self-dealing transactions, the transaction should be characterized as a loan or lease for correction and excise tax purposes.

Statute of Limitations on Collection of this Excise Tax

The IRS' position is that the Form 5330 filing does not start the statute of limitations on collection of the excise tax. Instead, it is the filing by the plan of the annual return (Form 5500 series) that commences the statute of limitation for transactions arising in that plan year.[115] If the transaction is reported on the annual return, a three-year statute commences. If the transaction is not reported, a six-year statute commences. Note that a continuing transaction, such as a loan or

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[112] GCM 39424.
[113] 22 EBC 2601, 112 T.C. No. 6 (Tax Ct. 1999).
[114] Rev. Rul. 2002-43, which concludes that the excise tax rate is redetermined as of the date of each prohibited transaction even where, as in the case of a loan, a new loan is deemed to occur as of the first day of each taxable year in which the loan remains outstanding.
[115] GCM 39475.

lease, starts a new transaction at the beginning of each tax year, for which a separate statute of limitations period would apply.

SECOND TIER TAX (THE 100 PERCENT TAX)

If a PT is not corrected, the IRS may impose a second tier tax which equals 100 percent of the amount involved.[116] Note that the initial tax under IRC §4975(a) may be reduced by paying the tax, even if the transaction is not corrected, because the taxable period will end with the assessment of the initial tax. However, the disqualified person can still be subject to the second tier tax if correction is not made.

Amount Involved

The amount involved is determined as described above for the initial tax, except the highest fair market value in effect during the taxable period is used.

Abatement of Tax if Correction is Made

The second tier tax is abated if correction is made within the 90-day period commencing on the date the IRS issues a notice of deficiency for the tax.[117] Correction does not abate the initial tax, although correction can reduce the taxable period during which the initial tax is calculated.

No Second Tier Tax if Transaction is Self-Correcting

No second tier tax will apply if the transaction, although prohibited, is self-correcting because of the overriding benefit provided to the plan.[118]

9.08: Title I Issues Relating to Prohibited Transactions

Title I of ERISA includes PT provisions that parallel those in the IRC. The fiduciary that causes a PT to occur may be liable to the plan for any losses. The **party-in-interest** who engages in the transaction also may be liable to the plan. The DOL may also impose civil penalties with respect to PTs.

TITLE I PROVISIONS RELATING TO PROHIBITED TRANSACTIONS

We have discussed previously the different types of PTs under the IRC. ERISA §406 includes provisions that parallel each of these PTs. The self-dealing rules under Title I also include one type of PT for which there is no parallel under the IRC. ERISA §408 contains the statutory exemptions that are available under Title I. These, too, parallel the IRC provisions. The following paragraphs

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116 IRC §4975(b).
117 IRC §4961.
118 *Zabolotny v. Commissioner*, 7 F.3d 774 (8th Cir.1993).

identify each type of PT and the related statutory exemptions, and provide cross-references to the parallel provisions in the IRC.

Sale or Exchange, or Leasing of Property

These transactions are covered in ERISA §406(a)(1)(A). The parallel IRC provision is IRC §4975(c)(1)(A).

Lending of Plan Assets or Other Extension of Credit

These transactions are covered in ERISA §406(a)(1)(B). The parallel IRC provision is IRC §4975(c)(1)(B).

Participant Loan Exemption

ERISA §408(b)(1) exempts certain participant loans from the PT rules. This exemption parallels IRC §4975(d)(1).

ESOP Loans

ERISA §408(b)(3) exempts certain loans to ESOPs from the PT rules. This exemption parallels IRC §4975(d)(3).

Furnishing of Goods, Services, or Facilities

These transactions are covered in ERISA §406(a)(1)(c). The parallel IRC provision is IRC §4975(c)(1)(c).

Reasonable Compensation for Services

ERISA §408(b)(2) exempts payments by the plan of reasonable compensation for office space or certain services. This exemption parallels IRC §4975(d)(2).

Evaluating Whether the Compensation is Reasonable. Historically, compliance by many fiduciaries with the obligation to enter into only contracts that provide for reasonable levels of compensation has been difficult. While fees charged directly to the plan sponsor or the plan may be readily discernible, indirect compensation—that is, compensation paid to the service provider from sources other than the plan or the sponsor, such as from financial institutions as part of the investment's built-in expenses—is hard for a fiduciary to identify. Information as to the amount of such expenses commonly can be found only in the prospectus for the investment, and that document does not necessarily identify who receives a share of those expenses as compensation.

In response to this problem, the DOL issued regulations in relation to the ERISA §408(b)(2) PT exemption that requires a "covered service provider" to properly disclose its expected compensation from all sources in relation to "covered services" being provided to a "covered plan." If these additional disclosure requirements are not met, the services contract will be considered to be unreasonable, thus resulting in a PT. As a result, the service provider will be subject to excise taxes and the possible requirement to disgorge all fees paid under the contract.[119]

These regulations apply to all contracts or arrangements in existence on July 1, 2012, and any contracts or arrangements for services that are new, renewed or renegotiated after that date.[120]

Because the concern here is that the arrangement will constitute a PT, the regulations apply only if there is a contract or arrangement between a service provider and a plan, and only if the fees are to be paid from the plan. If the contract or arrangement is between the service provider and the plan sponsor, and the plan sponsor pays all the fees from the company rather than the plan, there is no potential for a PT, so the regulations are not applicable. Nonetheless, unless the agreement between the parties provides specifically that no fees will be paid by the plan, it is more prudent for a service provider who does not want to risk engaging in a PT to make the required disclosure than to refrain from doing so.

Covered Service Provider. The required disclosures must be made by anyone who is a **covered service provider (CSP)**. A CSP is someone who enters into a contract or arrangement with a plan and reasonably expects to receive $1,000 or more in direct or indirect compensation for providing services to the plan. There are three categories of CSPs:

1. Fiduciaries,
2. Platform Providers to Participant-Directed DC Plans, and
3. Indirectly Compensated Service Providers.

It is possible that a CSP will fall into two or more of these categories.

Although the CSP is the contracting party, the actual services may be performed or the compensation received by any affiliate or subcontractor of the CSP.[121] For this purpose, an **affiliate** is:

- an entity that, directly or indirectly, controls, is controlled by, or is commonly controlled with the CSP; or
- a person who is an officer, director, employee or partner of the CSP.[122]

A **subcontractor** is a person or entity that is not an affiliate of the CSP, but, pursuant to a contract or arrangement with the CSP, reasonably expects to receive $1,000 or more in compensation for performing one or more services under the CSP's contract with the covered plan.[123]

Covered Plan. Only retirement plans covered by ERISA are covered plans, subject to the regulations. Therefore, IRA-based plans (such as SEPs or SIMPLE-IRAs), 457 plans and non-

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[119] DOL Reg. §2550.408b-2(c).
[120] DOL Reg., §2550.408b-2(c)(1)(xii).
[121] DOL Reg. §2550.408b-2(c)(1)(iii).
[122] DOL Reg. §2550.408b-2(c)(1)(viii)(A).
[123] DOL Reg. §2550.408b-2(c)(1)(viii)(F).

ERISA 403(b) plans are exempt. The DOL expects to introduce rules for health and welfare plans sometime in the future.[124]

Required Disclosures. The regulations require that CSPs provide detailed information about the services that they will provide and the compensation that they will receive for those services. If recordkeeping services are being provided as part of a bundled product, the service provider must assign a value to those services, so that the cost can be compared to that of unbundled providers. Fiduciaries and registered investment advisors (RIA) must identify that they are acting in a fiduciary or RIA capacity, and disclose the compensation that they receive for those services. Service providers must also identify fees that are associated with the termination of a contract.[125]

Timing of Disclosure. The disclosures required under the regulations must be provided "reasonably in advance" of the effective date of the contract or arrangement.[126] This term is not defined in the regulations, but it is clear from the context of the regulations that the plan fiduciary must have sufficient time to review and consider the disclosure information prior to entering into the contract.

If there are changes to the disclosed information, a new disclosure must be provided within 60 days of the change. Exceptions apply if the information is not available in that timeframe due to circumstances beyond the CSP's control. In that situation, the CSP must provide the required information as soon as possible.[127]

Disclosure Failures. If the CSP fails to make the required disclosures, the PT exemption of ERISA §408(b)(2) will not apply, and the provision of services and charging of fees will be a PT. At the least, the service provider will be liable for a 15 percent excise tax on the amount of fees charged. There is a second tier tax of 100 percent of the fees charged if the PT is not corrected in a timely manner. How to correct the transaction is somewhat unclear, other than to give the disclosures as soon as possible. However, it is also within the IRS's enforcement powers to require that the PT be "reversed" — that is, to have the service provider return to the plan any fees that have been paid.

The plan fiduciary that engaged in the contract (referred to as the "responsible plan fiduciary" in the regulations) can be liable for a breach of his or her duty for having entered into the contract that was a PT. The regulations provide that, if the fiduciary reasonably believed that the CSP had complied with the disclosure obligation, he or she can avoid liability if:

- Upon discovery of the noncompliance, the fiduciary provides a written request to the CSP for the disclosure;

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[124] DOL Reg. §2550.408b-2(c)(1)(ii); see also, Preamble, §B.2.
[125] DOL Reg. §2550.408b-2(c)(3).
[126] DOL Reg. §2550.408b-2(c)(1)(v)(A).
[127] DOL Reg. §2550.408b-2(c)(1)(v)(B).

- If the CSP either fails to make the required disclosure within 90 days or refuses to do so, the fiduciary notifies the DOL of such failure in the manner outlined in the regulations within 30 days of either the expiration of the 90-day period or the date of the refusal; and
- The fiduciary considers whether it is appropriate to terminate the service arrangement in light of the failure to disclose, taking into account the nature of the failure; the ability, qualifications and cost of replacing the CSP; and the CSP's response to the notification of the failure.[128]

Compensation to Fiduciary; Reimbursement for Expenses

We previously discussed the exemption for reimbursement of direct expenses incurred by a fiduciary and the prohibition on payment of compensation to a fiduciary who is a full-time employee of the employer, as prescribed by IRC §4975(d)(10). The parallel Title I provisions are found in ERISA §408(c)(2).

Use of Plan Assets by Party-in-Interest

These transactions are covered in ERISA §406(a)(1)(D). The parallel IRC provision is IRC §4975(c)(1)(D). ERISA §408(c)(1) permits a fiduciary to receive benefits due him or her under the plan as a participant or beneficiary. This rule parallels IRC §4975(d)(9).

Self-Dealing

These transactions are covered in ERISA §406(b). ERISA §406(b)(1) parallels IRC §4975(c)(1)(E), relating to dealing with the plan assets in a manner that benefits the fiduciary. ERISA §406(b)(3) parallels IRC §4975(c)(1)(F), relating to the receipt of consideration from a third party involved in the transaction.

Representation of Party with Adverse Interests to the Plan

ERISA §406(b)(2) states that a fiduciary is engaged in a PT if he or she acts, either in his or her individual capacity or in any other capacity, on behalf of a party whose interests are adverse to the interests of the plan or the interests of the participants or beneficiaries. This is a conflict of interest provision. There is no parallel IRC provision, so this type of violation is subject solely to DOL enforcement under Title I, and not to the excise tax provisions imposed by the IRS.

The other party represented by the fiduciary need not be a party-in-interest with respect to the plan for this to be a PT.[129]

Transactions Between Plans

An issue under ERISA §406(b)(2) arises when a transaction occurs between plans represented by the same fiduciary. In *Cutaiar v. Marshall*,[130] the court held that ERISA §406(b)(2) was violated when the same trustees for two plans allowed for the transfer of assets from one plan to another,

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[128] DOL Reg. §2550.408b-2(c)(1)(ix)(G).
[129] *Reich v. Compton*, 57 F.3d 270 (3rd Cir. 1995).
[130] 590 F.2d 523 (3rd Cir. 1979).

where the plans were maintained by the same employer, but the plans did not cover identical groups of participants. In Advisory Opinion 2003-10A, the DOL ruled that the exchange of plan assets among plans participating in a master trust is a violation of ERISA §406(b)(2) to the extent that a common fiduciary represents all plans involved in the transaction.

Dual Capacities

ERISA §408(c)(3) permits a fiduciary to serve in more than one capacity, such as an officer, employee, agent, or other representative of a party-in-interest. The parallel IRC provision is IRC §4975(d)(11).

Investments in Qualifying Employer Securities and Qualifying Employer Real Property

ERISA §406(a)(1)(E) makes it a violation to acquire any employer security or employer real property unless the requirements of ERISA §407 are satisfied. ERISA §408(e) also exempts from the ERISA §407 requirements certain investments in qualifying employer securities and qualifying employer real property made by an eligible individual account plan. IRC §4975(d)(13) provides excise tax relief for transactions that are covered by ERISA §408(e).

S Corporations and Unincorporated Businesses

Many of the statutory exemptions are inapplicable for certain owners of S corporations and unincorporated businesses. ERISA §408(d) provides the rule under Title I. Note that certain plans maintained by unincorporated businesses are not covered by Title I of ERISA anyway.

Exemptions

ERISA §408(a) grants the DOL the authority to issue exemptions from the PT rules. Some of the exemptions are issued on a class basis.

ENFORCEMENT OF THE TITLE I PROHIBITED TRANSACTION RULES

The fiduciary may be liable for any losses incurred by the plan as a result of the PT. If the fiduciary personally profits from the transaction, he or she may be liable to turn over the profits to the plan for the benefit of the plan participants and their beneficiaries. The DOL enforces these rules through the civil action provisions in Title I of ERISA. The DOL will also seek restitution on behalf of the plan against nonfiduciaries who are parties-in-interest engaging in a PT with the plan, pursuant to ERISA §502(a)(5), and a participant, beneficiary or fiduciary may seek similar relief pursuant to ERISA §502(a)(3).

Civil Penalties against Parties-in-Interest

ERISA §502(i) authorizes the DOL to assess a civil penalty on a party-in-interest who engages in a PT with the plan. The civil penalty parallels the excise tax provisions under IRC §4975(a) and (b). In DOL Reg. §2560.502i-1, the DOL adopts, by cross-reference, the Treasury regulations relating to the excise tax to calculate the applicable civil penalty. The DOL procedures for assessment of the civil penalty are published in DOL Reg. §§2570.1 through 2570.12.

If the plan is a qualified plan or an IRA, the civil penalty provisions of ERISA §502(i) are not applicable.[131] This eliminates duplication of penalties against persons who are subject to excise taxes under IRC §4975, or, in the case of an IRA, the tax sanctions imposed by IRC §408(e).

Penalties on Fiduciary

ERISA §502(l) imposes a 20 percent penalty on a fiduciary or other person, which is calculated on the basis of amounts recovered pursuant to a fiduciary violation under Title I of ERISA. The ERISA §502(l) penalty is reduced by any civil penalty under ERISA §502(l) imposed on the fiduciary or other person involved in the transaction. The ERISA §502(l) penalty is relieved if the fiduciary corrects the PT under the DOL's Voluntary Fiduciary Correction (VFC) Program.

9.09: Review of Key Concepts

- Identify a disqualified person.
- Identify a party-in-interest.
- For what purpose are disqualified persons and parties-in-interest identified?
- What types of transactions are PTs?
- How does a class exemption differ from an administrative exemption?
- Give examples of transactions that are class exemptions.
- What are the consequences of engaging in a PT?
- Calculate the first and second tier penalties that apply to a PT.
- How are PTs corrected and reported?
- Identify who is a covered service provider under the fee disclosure regulations.
- What are the consequences of failing to make required fee disclosures?

9.10: For Practice – True or False

1. A disqualified person is always a party-in-interest.
2. A party-in-interest is always a disqualified person.
3. A PT does not necessarily mean plan disqualification.
4. The PT rules do not apply to plans whose assets are participant-directed.
5. A plan may not sell or lease property to a disqualified person.
6. Loans to plan participants are exempt from the PT rules as long as certain conditions are met.
7. A class exemption provides relief from the excise tax under the IRC and the fiduciary liability consequences under ERISA.

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[131] ERISA §502(i), last sentence.

8. An excise tax of 100 percent of the amount of the PT may be imposed if the transaction is not corrected in a timely manner.
9. The plan is liable for payment of the PT excise tax.
10. The DOL may assess civil penalties on a party-in-interest involved in a PT.

9.11: Sample Test Questions

1. All of the following are disqualified persons under IRC §4975, EXCEPT:
   A. An accountant who prepares Form 5500 for a plan
   B. A brother of a 45 percent owner of the plan sponsor
   C. A plan trustee's father
   D. A member of the board of directors of the plan sponsor
   E. A union whose members are covered by the plan
2. All of the following transactions are exemptions from the PT rules, EXCEPT:
   A. The purchase by the plan of the building in which the sponsor conducts his or her business
   B. Reasonable compensation paid for necessary accounting services for the plan
   C. The sale of life insurance to a participant from the plan
   D. The investment of assets of the plan in a bank that is also the plan's trustee
   E. A loan to a leveraged ESOP from the plan sponsor to purchase employer stock
3. Which of the following statements regarding consequences of PTs is/are TRUE?
   I. Form 5330 is used to transmit the applicable excise tax to the IRS.
   II. EPCRS is available to correct PTs.
   III. The initial excise tax is 15 percent of the amount involved.
   A. I only
   B. II only
   C. I and II only
   D. I and III only
   E. I, II and III
4. All of the following are covered service providers under the fiduciary fee disclosure regulations, EXCEPT:
   A. Registered investment advisor compensated by plan assets
   B. Investment platform provider whose fee is paid by the plan
   C. Trustee who is paid a percentage of the plan assets from the plan
   D. Third-party administrator paid partly through 12b-1 fees generated by plan investments
   E. Plan auditor paid by the plan sponsor
5. Which of the following statements regarding consequences of failing to comply with the required fiduciary fee disclosures is/are TRUE?
   I. The PT exemption will not apply to the covered service provider.
   II. The covered service provider will be liable for a 15% excise tax on the amount of fees charged.

III. The IRS may require the service provider to return to the plan any fees that have been paid.

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.

9.12: Solutions to True or False Questions

1. True.
2. False. A party-in-interest is not always a disqualified person.
3. True.
4. False. Plans that are participant-directed are not exempt from the PT rules.
5. True.
6. True.
7. True.
8. True.
9. False. The disqualified person is liable for payment of the excise tax on the PT.
10. True.

9.13: Solutions to Sample Test Questions

1. The answer is **B**. A brother is not considered a family member under the attribution rules applicable to PTs. A family member would be included as a disqualified person under IRC §4975 only if the relative's ownership is at least 50 percent.
2. The answer is **A**. If the sponsor owns the building, this would be a sale of property between the sponsor and the plan. If a third party owns the building, the sale to the plan would then violate the use of plan assets for the sponsor's benefit. Both are PTs.
3. The answer is **D**. EPCRS is not currently available to correct PTs.
4. The answer is **E**. If the service provider's fees are paid by the plan sponsor rather than the plan, the disclosure fee disclosure rules do not apply to the service provider.
5. The answer is **E**. All statements are True.

CHAPTER 10:

DISTRIBUTIONS UPON DEATH AND LIFE INSURANCE

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10.01: Key Terms

- 100-times rule
- 402(f) notice
- Annuity starting date
- Automatic rollover rule
- Blanket consent
- Cash-out limit
- Cash surrender value
- Face amount
- Incidental death benefit requirement
- Incidental life insurance benefit
- Involuntary distribution
- Mandatory distributions
- Net insurance proceeds
- One-year marriage rule
- Percent-of-contributions rule
- Qualified joint and survivor annuity (QJSA)
- Qualified preretirement survivor annuity (QPSA)
- Reserve accumulation
- Rollover notice
- Seasoned contributions
- Significant detriment
- Special tax notice
- Term cost

10.02: Introduction

One of the more complex areas of qualified plan law relates to distributions. Congress sought to protect both participants and spouses with the rules of the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act (ERISA), and it is clear that this protection was perceived as most needed at the time that money is taken from the plan.

Congress was concerned about a participant electing a method of benefit payout that would leave his or her spouse with no benefits upon the participant's death. The problem was particularly acute in situations where there was a spouse who did not work outside the home (generally perceived to be a wife and mother). Congress enacted rules requiring a benefit paid from a pension plan, and from certain profit-sharing and stock bonus plans as well, to be in the form of an annuity payable over the joint lifetimes of the participant and his or her spouse, unless the spouse affirmatively agrees to a different benefit form. Furthermore, that agreement must be in writing and witnessed, providing the spouse with additional protection from abuses by the participant.

Whether the joint and survivor annuity rules have truly protected spouses in the manner intended is up for discussion. However, it does add layers of complexity to the process of actually providing benefits and designating beneficiaries, and a service provider to a plan must be aware of these requirements to properly administer the plan.

The law also permits certain benefits to be provided by insurance, including life, accident and health benefits. There is a limit on the amount of these benefits – they must be incidental to the normal purpose of the plan. This ambiguous phrase means that the plan must predominantly provide retirement benefits. All other benefits must be, to some extent, beside the main point. If the other benefits exceed these incidental limits, the plan may be disqualified because it ceased to be mainly a retirement plan, and has become, instead, a welfare benefit plan.

10.03: Qualified Joint and Survivor Annuity (QJSA)

A plan must provide a **qualified joint and survivor annuity (QJSA)**, unless the plan is exempt from this requirement. The general application of the QJSA requirement is stated in IRC §401(a)(11). The specific requirements are detailed in IRC §417. If the QJSA rule applies to a participant, then the plan must follow certain procedures in determining how to pay the participant's benefit. Parallel requirements are found in ERISA §205, so these rules are also enforceable under ERISA. The citations in the material below are to the IRC sections, rather than to the ERISA sections. These rules were covered in QKA courses. They are being covered again, as many of them also apply to the qualified pre-retirement annuity (QPSA), defined and discussed in the next section of this course, and both QJSA and QPSA distributions have death payment features.

WHAT IS THE QJSA?

The QJSA is a joint and survivor annuity that provides recurring payments to the participant for his or her life, with payments that continue for the spouse's life following the participant's death. If the spouse does not outlive the participant, payments are made only for the participant's lifetime. The payments made to the spouse must be no greater than 100 percent and no less than 50 percent of the payment made during the participant's life.[1] A joint and 50 percent survivor annuity would provide the surviving spouse with an annuity payment that is 50 percent of the payment the participant received when he or she was alive. A joint and 100 percent survivor annuity would provide the surviving spouse with the same annuity payment that the participant received during his or her lifetime. The QJSA is the joint and survivor annuity that the participant is required to receive, absent any election to the contrary. The plan document must specify the survivor annuity percentage that will apply to the QJSA. The plan may provide two or more survivor annuity percentage options (e.g., 50 percent and 100 percent), and let the participant elect which survivor annuity percentage will apply to the participant's QJSA benefit.[2]

Unmarried Participant Must be Offered Life Annuity

If the participant is not married, the QJSA, that is, the mandatory form of benefit absent the participant's election to the contrary, is simply a life annuity, which provides payments during the participant's life.[3] The statutory provision does not specifically require the payment of a QJSA to an unmarried participant.[4]

QJSA under a Defined Contribution Plan

A defined contribution plan may satisfy the QJSA requirement by purchasing a nontransferable annuity contract from an insurance company. The entire vested account balance, including after-tax employee contributions and rollover contributions, must be used to purchase the QJSA. To

[1] IRC §417(b).
[2] Treas. Reg. §1.401(a)-20, Q&A-16.
[3] Treas. Reg. §1.401(a)-20, A-25; see also Franklin v. Thornton, 983 F.2d 939 (9th Cir. 1993).
[4] *Franklin v. Thornton*, 983 F.2d 939 (9th Cir. 1993).

determine the QJSA under a plan with a 401(k) arrangement, the account balance includes pre-tax elective deferrals and designated Roth contributions, including catch-up contributions. The level of annuity payment received under the QJSA will depend on:

- The value of the account balance that is used to purchase the annuity,
- The age of the participant,
- The age of the participant's spouse (if applicable), and
- The annuity purchase rates of the insurer that is issuing the contract.

If You're Curious . . .

Reduction for Security Interest Attributable to Participant Loan

A participant's benefit may be subject to a security interest for an outstanding participant loan. The benefit may be reduced for the security interest upon default or if repayment of the loan is accelerated when the participant elects distribution. This reduction of the benefit for the security interest does not violate the QJSA requirement.[5]

Deemed IRA Accounts Excluded

A qualified plan may permit participants to make IRA contributions to the plan.[6] These deemed IRA accounts in a plan are to be treated as IRAs for all purposes of the IRC.[7] Thus, the QJSA rules are not required to be applied to distributions from deemed IRA accounts held by the plan.[8]

Source of Rollover Contribution Not Important

The application of the QJSA requirements to rollover contributions is not dependent on the source of that rollover contribution. For example, if a defined benefit plan receives a rollover contribution from a profit-sharing plan that was exempt from the QJSA rules, subsequent payment of the rollover contribution from the defined benefit plan is subject to the QJSA rules because the QJSA requirements always apply to a defined benefit plan. Similarly, even though 403(b) plans generally are not subject to the QJSA rules, and governmental 457(b) plans and IRAs are never subject to the QJSA rules, once a distribution of any of these types of plans is rolled over to a qualified plan that is subject to the QJSA rules, the QJSA requirements will apply to any subsequent distribution of the rollover contribution from the recipient qualified plan. No exceptions from the QJSA rules have been created under IRC §§401(a)(11) and 417 merely because a portion of the participant's benefit is attributable to rollovers from non-QJSA covered plans.

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[5] IRC §417(f)(5).
[6] IRC §408(q).
[7] IRC §408(q)(1).
[8] Treas. Reg. §1.408(q)-1(e)(1), which provides that the rules applicable to distributions from qualified plans do not apply to distributions from deemed IRAs.

PLANS THAT MUST PROVIDE THE QJSA

A QJSA must be provided to all participants under a defined benefit plan, money purchase pension plan or target benefit plan.[9] A profit-sharing plan or stock bonus plan is not required to provide a QJSA, if it satisfies certain requirements. A 401(k) plan is merely a type of profit-sharing plan or stock bonus plan (unless it is maintained as part of a pre-ERISA money purchase pension plan), so a 401(k) plan is not required to provide a QJSA if the exemption requirements are satisfied.

A profit-sharing plan or stock bonus plan is exempt from the QJSA obligations if all the requirements described below are satisfied.[10] Failure to satisfy any one requirement will subject the participant to the QJSA rules. It is possible that these requirements may be satisfied only for some of the participants. In that case, the plan would have to make the QJSA available at least to the participants who do not satisfy the exemption requirements.[11] Items one through four below are what the plan must do to be exempt from the QJSA:

Spouse Must Be Beneficiary in Full

This requirement is satisfied if the participant's benefits are payable in full to the surviving spouse, unless the spouse has consented to another beneficiary. As part of this requirement, the death benefit must be available to the spouse within a reasonable period following the participant's death (generally no more than 90 days), and the benefit payable to the spouse must be adjusted for gains or losses occurring after the participant's death.[12]

A profit-sharing plan or stock bonus plan that currently offers the QJSA may be amended to eliminate that option without having to protect it with respect to existing account balances.[13] If the QJSA is eliminated, the person drafting the amendment must make sure that the death benefit provisions of the plan satisfy the above requirement, particularly in the case of preretirement death benefits. Some plans provide that spousal consent regarding who is a beneficiary is required only with respect to the portion of a preretirement death benefit that is payable in the form of a qualified pre-retirement survivor annuity (which is discussed below). If the QJSA is being eliminated, the spouse's consent is required in relation to the entire preretirement death benefit.

Life Annuity Option Cannot Be Elected

This requirement is satisfied if there is no life annuity option in the plan, or, if there is, the participant does not elect into the plan's life annuity distribution option. In most plans drafted to

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[9] IRC §401(a)(11)(B)(I) and (ii).
[10] IRC §401(a)(11)(B)(iii).
[11] Treas. Reg. §1.401(a)-20, A-3.
[12] Treas. Reg. §1.401(a)-20, A-3(b).
[13] Treas. Reg. §1.411(d)-4.

be exempt from the QJSA rules, no life annuity option is available, so this rule will be satisfied for all participants.

If a participant is otherwise exempt from the QJSA requirement, the QJSA rule is not applicable unless the participant actually elects a life annuity option. However, once a life annuity option is elected by the participant, the QJSA requirements specified in IRC §417 will thereafter apply to the participant's entire account balance, unless a separate accounting is made of the portion of the account balance subject to the life annuity election.[14]

Account Balance Does Not Include Direct Transfer from a Plan that was Subject to QJSA

For payment of the participant's benefit to be exempt from the QJSA rule, the participant's account balance must not include a direct transfer from another plan that was subject to the QJSA rule. If this condition is not satisfied, and the plan makes a separate accounting of the transferred benefit, the plan may provide that the QJSA rule is limited to just the separate account that reflects the transferred benefit.[15] If there is no separate accounting, then the participant's entire account balance must be subject to the QJSA rule.

A direct transfer described in the prior paragraph does not include a rollover or an elective transfer of distributable benefits. The acceptance of a rollover or elective transfer from a plan that is subject to the QJSA rule does not cause the recipient plan to be subject to the QJSA rule with respect to the participant electing the rollover or elective transfer. Even the amount rolled over or transferred in such a transaction is not subject to the QJSA rule. Why does the IRS distinguish rollovers and elective transfers from other types of transfers? Because one condition to electing a rollover or elective transfer of distributable benefits is that the participant making the election must waive the QJSA benefit, and if the participant is married, the spouse must consent to that waiver. This waiver eliminates the QJSA provisions with respect to the benefits that are rolled over or transferred to the recipient plan.

A defined contribution plan may offer employees the right to make an elective transfer of benefits that are not otherwise distributable to another defined contribution plan if, because of a business transaction (e.g., asset or stock sale) or a change in employment status, the employees are no longer entitled to additional allocations under the transferor plan.[16] Because these elective transfers are made when the benefits are not otherwise distributable, if the transferee plan does not otherwise provide for the QJSA rules, it must continue to meet these requirements with respect to the transferred benefits.[17]

EXAMPLE 10-1. Merger of a QJSA Plan into Non-QJSA Plan. B is a participant in a money purchase pension plan and a profit-sharing plan maintained by B's employer. The employer terminates the money purchase pension plan and

[14] Treas. Reg. §1.401(a)-20, A-4.
[15] Treas. Reg. §1.401(a)-20, A-5(b).
[16] Treas. Reg. §1.411(d)-4, Q&A-3(b).
[17] Treas. Reg. §1.411(d)-4, Q&A-3(b)(2).

merges the plan into the profit-sharing plan. At the time of the merger, the profit-sharing plan is exempt from the QJSA rule. None of the money purchase pension plan participants are given an opportunity to elect a distribution from the money purchase pension plan pursuant to the plan's termination. The QJSA rule must continue with respect to the money purchase assets transferred into the profit-sharing plan in the merger transaction. B's profit-sharing plan account balance need not be subject to the QJSA rule merely because of the merger, as long as there is adequate separate accounting of the money purchase assets and the plan limits the QJSA provisions to those assets.

EXAMPLE 10-2. Transfer from QJSA Plan Made by Direct Rollover. Suppose in the prior example that the money purchase pension plan is not merged into the profit-sharing plan. Instead, a distribution is made available to participants from the terminated money purchase pension plan. Participant A elects a lump sum distribution from the money purchase pension plan by waiving the QJSA (with A's spouse's consent). A also elects to have the lump sum distribution directly rolled over to the profit-sharing plan. The rollover of the money purchase account does not cause the plan to fail the exemption requirement. Therefore, A's rollover account in the profit-sharing plan is not subject to the QJSA rule, even though the rollover assets were earned and allocated under the money purchase pension plan (unless one of the other conditions for the exemption is not satisfied).

If this transaction had been accomplished through an elective transfer rather than a direct rollover, but pursuant to the participant's election, the recipient profit-sharing plan would still not have to apply the QJSA rule to the transferred benefits solely because of the elective transfer.

No Floor-Offset Arrangement with Defined Benefit Plan

The account balance in the profit-sharing plan or stock bonus plan that is seeking exemption from the QJSA requirements cannot be part of a floor-offset arrangement with a defined benefit plan maintained by the employer.[18] This means that the participant's benefits in the defined benefit plan must not be offset (or reduced) by the value of the participant's account balance in the profit-sharing plan or stock bonus plan.

If the plan does not meet the preceding QJSA exemption requirements, the QJSA must be the only form of benefit available under the plan, or it must be the required payment method unless the QJSA waiver and consent requirements are satisfied.

In some cases, the QJSA rule is applicable to some (but not all) of the plan participants. This can happen when a non-pension plan does not satisfy all of the exemption requirements described

[18] Treas. Reg. §1.401(a)-20, A-5(a).

above for some of the participants. For example, a profit-sharing plan might permit life annuity elections, but only the participants who make those elections are subject to the QJSA rule. Or, a profit-sharing plan might have received transfers from another plan that was subject to the QJSA rules, but those transfers were made for only certain participants. In that case, only the participants who have transfers from the other plan would have to be subject to the QJSA rule. However, if the profit-sharing plan does not define the surviving spouse as the automatic beneficiary of the profit-sharing account, in the absence of a valid spousal consent to an alternate beneficiary, the QJSA rule would be applicable to all distributions from the plan.

MANDATORY PAYMENT IN THE QJSA FORM

If the QJSA rule applies to a participant, the QJSA form of payment is mandatory unless the participant elects a different form of payment available under the plan. An election by a married participant to take a different form of payment, even if it is only from a portion of the participant's benefit, is not permitted unless the participant's spouse also consents to the election. If the lump sum value of the participant's benefit is $5,000 or less, a lump sum (or, in absence of any direction by the participant, a lump sum rollover to an IRA) can be paid instead of the QJSA, without obtaining the participant's election or the spouse's consent.

WHAT IS A QUALIFIED OPTIONAL SURVIVOR ANNUITY (QOSA)?

A plan that is subject to the QJSA rules must also provide participants a second annuity option, called a **qualified optional survivor annuity** or QOSA.[19] The value of the QOSA is the actuarial equivalent of the QJSA (i.e., the two benefits have the same projected value), but the payments are somewhat different in structure. The payment structure of the QOSA depends on the type of QJSA that is provided.

If the QJSA provides for a survivor annuity of less than 75 percent, the QOSA must provide for a 75 percent survivor annuity. If the QJSA provides for a survivor annuity that is greater than or equal to 75 percent, the QOSA must be a 50 percent survivor annuity.[20] For both the participant and the spouse, the monthly benefit payment amounts will be different under the QOSA, in order to achieve the actuarial equivalent of (i.e., provide the same projected value of benefit as) the QJSA.

EXAMPLE 10-3. Qualified Optional Survivor Annuity. E is a participant in a profit-sharing plan that offers annuities. E's vested account balance is $100,000. The plan provides for a 50 percent QJSA, and E has been advised that this would provide E with an income of $500 per month during E's lifetime, with a survivor benefit payable to E's spouse upon E's death equal to $250. The plan administrator also advises E that, under the QOSA, E would be provided with a

[19] IRC §417(a)(1)(A)(ii).
[20] IRC §417(g).

lifetime annuity, followed by a 75 percent survivor annuity. Under this option, the amount payable during E's lifetime is decreased to $400, because the share payable to E's spouse upon E's death would increase to 75 percent of that amount, or $300.

The participant may elect the QOSA form of benefit in lieu of the QJSA without obtaining his or her spouse's consent.

10.04: Preretirement Death Benefits

A preretirement death benefit is any benefit the plan pays to a beneficiary if the participant passes away before retiring. To determine the form of preretirement death benefit payable to a participant's beneficiary, the first consideration is whether the participant has a surviving spouse. An unmarried participant can name the beneficiary of his or her benefits, if the plans so permits. On the other hand, special rules apply to married participants.

The preretirement death benefit that must be available for the spouse of a married participant depends on whether the QJSA rule applies to the plan. If the QJSA rule applies, a **qualified preretirement survivor annuity (QPSA)** must be available to the spouse. If the QJSA rule does not apply, any death benefit must still be payable in full to the surviving spouse (although not in the form of a QPSA), unless the spouse has consented to another beneficiary.

The rules described in this section are required both under the IRC for plan qualification purposes and under Title I of ERISA. The IRC rules are found in IRC §401(a)(11) and IRC §417. The ERISA rules are found in ERISA §205. The inclusion of these rules in ERISA §205 makes these rules enforceable under ERISA §502.

EXPLANATION OF THE QPSA

A QPSA is a life annuity payable to the surviving spouse after the participant's death.[21] A defined contribution plan satisfies the QPSA requirement by purchasing a nontransferable life annuity contract from an insurance company for the spouse. The amount used to purchase the QPSA must be no less than 50 percent and no more than 100 percent of the participant's vested account balance, as specified in the plan document.[22] The vested account balance, for purposes of determining the QPSA, includes any portion that becomes vested upon the participant's death, and the proceeds of life insurance contracts purchased for the participant's account.[23]

EXAMPLE 10-4. Amount of QPSA. A profit-sharing plan provides that if a participant dies while still employed by the employer, the participant's account balance becomes 100 percent vested. A participant, whose account balance is

[21] IRC §417(c).
[22] IRC §417(c)(2).
[23] Treas. Reg. §1.401(a)-20, A-12(b).

> $35,000, dies on June 1. As of the date of death, the participant was only 60 percent vested in the participant's account balance derived from employer contributions. Due to the accelerated vesting provision in the plan, the participant's account becomes 100 percent vested because the participant was still employed by the company on the participant's date of death. The QPSA must be payable with no less than 50 percent of the entire account balance (i.e., $17,500) because the account became 100 percent vested as of the date of death.

The plan must permit the spouse to commence payment of the QPSA within a reasonable time after the participant's death.[24]

The participant may waive the QPSA in favor of a different beneficiary and/or a different type of death benefit. Such a waiver is effective only if the spouse consents to both the beneficiary and the alternate form. The procedure for waivers is discussed more thoroughly below.

WAIVER OF THE QPSA BENEFIT

A participant must receive an explanation of the QPSA and the opportunity to waive the benefit in favor of another beneficiary. The QPSA explanation must contain:

- A general description of the QPSA;
- The circumstances under which it will be paid if elected;
- The availability of the election of the QPSA; and
- If applicable, the financial effect of the election of the QPSA on the participant's benefits (i.e., an estimate of the reduction of the participant's estimated normal retirement benefit that would result from an election of the QPSA).[25]

Information regarding the financial effect of the election to waive the QPSA may be provided through a general description (e.g., in the form of a chart showing the reduction at a representative range of participant ages), accompanied by a statement that the participant may request an estimate of the reduction to his or her projected normal retirement benefit.[26] If the plan does not reduce the normal retirement benefit because of a QPSA election, then the information referenced in the last bullet is not required.

Timing of Explanation

The QPSA explanation must be provided during the period that begins with the plan year in which the participant attains age 32 and ends with the plan year in which the participant attains age 35.[27] If an employee becomes a participant after this period, the explanation must be given no later than one year following his or her initial participation date. Similarly, if the participant becomes subject to the QPSA after the normal notice period, the explanation must be given no

[24] Treas. Reg. §1.401(a)-20, A-22(b).
[25] Treas. Reg. §1.417(a)(3)-1(b)(1).
[26] Treas. Reg. §1.417(a)(3)-1(d)(3).
[27] IRC §417(a)(3)(B)(ii).

later than one year after the QPSA becomes applicable.[28] This might occur, for example, when a profit-sharing plan that previously satisfied the QJSA exemption no longer meets the exemption because annuity distribution options are added to the plan.

Waiver Election

A waiver of the QPSA may be made at any time after the first day of the plan year in which the participant attains age 35.[29]

The plan may permit the participant to waive the QPSA before age 35, but the QPSA waiver becomes invalid at age 35, and a new notice and waiver period must be provided.[30] If a participant separates from service before age 35, he or she must have an opportunity to waive the QPSA benefit at that time. If the participant has not received the explanation at the time of his or her separation from service, the notice must be given no later than one year after the separation (unless full distribution of the benefit is made to the participant before that time).[31]

Spousal Consent to Waiver

Spousal consent to the QPSA waiver must:

- Be in writing,
- Acknowledge the effect of the participant's election, and
- Be witnessed by either a notary public or plan representative.[32]

The spouse's consent is not valid unless he or she consents to the naming of any nonspouse beneficiary that is designated to receive the preretirement death benefit. The QPSA waiver and the spouse's consent to that waiver do not have to address the form of payment that will be made to the nonspouse beneficiary.[33] The spouse's consent cannot be satisfied in a prenuptial agreement or other contract entered into before marriage.[34] However, a timely disclaimer of the QPSA benefit by the surviving spouse, which is made after the participant's death, will be treated by the IRS as a waiver of the QPSA benefit.[35]

Exception to Waiver Rules if QPSA is Fully Subsidized

If the QPSA is fully subsidized, then no waiver election is available and the QPSA is automatic. A QPSA is fully subsidized if the participant's benefit is not reduced because of the QPSA

[28] Treas. Reg. §1.401(a)-20, Q&A-35(a).
[29] IRC §417(a)(6)(B).
[30] Treas. Reg. §1.401(a)-20, A-33(b).
[31] Treas. Reg. §1.401(a)-20, Q&A-35(b).
[32] IRC §417(a)(2)(A).
[33] Treas. Reg. §1.401(a)-20, A-31(b)(2).
[34] Treas. Reg. §1.401(a)-20, A-28.
[35] GCM 39858. The disclaimer requirements are described in IRC §2518.

coverage, and if no charge to the participant is made for the coverage. Therefore, a QPSA is fully subsidized in a defined contribution plan.[36]

Sample Notice and Consent Forms

IRS Notice 97-10 provides sample language for explaining the QPSA to the spouse. The notice also includes sample waiver forms that the participant and spouse may execute to waive the QPSA benefit. An employer is not required to use the sample language, and may opt instead to use its own forms.

OTHER QPSA RULES

If the QPSA is payable to the surviving spouse, there are two consent rules that might be applicable:

- A spouse cannot be required to receive the QPSA before the participant would have reached normal retirement age (or age 62, if later).[37]
- The plan may permit the spouse to elect an optional form of payment instead of the QPSA.[38] The plan cannot pay one of those optional forms without the spouse's consent.

Lump Sum Permitted if Value of QPSA Does Not Exceed $5,000

The plan may provide for a lump sum payment to the spouse if the value of the QPSA does not exceed $5,000.[39] In a defined contribution plan, the value is based on the amount of the vested account balance that would be used to purchase the QPSA. When this rule applies, the lump sum is paid without having to first obtain the spouse's consent, and the spouse is not entitled to elect any forms of payment that would otherwise be available had the value of the QPSA exceeded $5,000.

Value Not Required to Include Rollover Contributions to Determine If Lump-Sum Exception Applies

IRC §411(a)(11)(D) permits a plan to disregard the amount attributable to rollover contributions to determine whether a participant's vested account balance exceeds $5,000 for purposes of the involuntary distribution rule under IRC §411(a)(11). Any portion of the value of the QPSA that is attributable to a rollover contribution to the participant's account may be disregarded to determine if the value of the QPSA exceeds $5,000. This approach, however, is not required, and the plan document must be written to reflect this rule for the plan to be able to disregard rollover contributions in determining whether an involuntary cash-out of the value of the QPSA is permissible. When this rule applies, a lump sum is paid to the spouse even though the actual

[36] Treas. Reg. §1.401(a)-20, A-38(b).
[37] Treas. Reg. §1.417(e)-1(c).
[38] Treas. Reg. §1.401(a)-20, A-31(b)(3).
[39] IRC §417(e)(1).

lump-sum payment will exceed $5,000 because it includes the amount attributable to the rollover contribution(s).

Spouse has Rollover Option

Although the rules described above allow for an involuntary cash-out of the value of the QPSA, the surviving spouse would still get an opportunity to make a direct rollover election with respect to the lump sum payment.[40] An eligible rollover distribution includes distributions to surviving spouses that satisfy that definition.[41] The notice requirements of IRC §402(f), pertaining to the direct rollover option, are applicable as well.

One-Year Marriage Rule

The plan may require the participant and spouse to be married for the one-year period ending on the date of the participant's death for the QPSA rules to apply.[42] If the **one-year marriage rule** is not satisfied, no QPSA is payable to the surviving spouse. Whether any preretirement death benefit is payable in that case would depend on the non-QPSA provisions of the plan.

EXAMPLE 10-5. One-Year Marriage Rule Not Satisfied. A participant in a profit-sharing plan gets married on April 10. The participant dies on September 30 of the same year. The participant's beneficiary designation form names the participant's children from a prior marriage as the beneficiaries. The participant had not changed the form before the participant's death. The new spouse had never consented to the beneficiary form. The profit-sharing plan is exempt from the QJSA requirements.

The plan provides that the surviving spouse is the automatic beneficiary, in full, unless:

- The spouse consents to any nonspouse beneficiary designated by the participant; or

- The participant and the spouse are not married for the one-year period ending on the date of the participant's death.

Because the plan provides for the one-year marriage rule and the participant was married for less than one year on the date of death, the surviving spouse is not the automatic beneficiary, and the beneficiary designation is valid without spousal consent. Thus, the children from the prior marriage are entitled to the death benefit.

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[40] IRC §401(a)(31).
[41] IRC §402(c)(9).
[42] IRC §417(d)(1).

EXAMPLE 10-6. One-Year Marriage Rule Not Satisfied But Surviving Spouse is Designated Beneficiary. Suppose, in the prior example, that on May 10, one month after the participant married, the participant changed the beneficiary designation to name the new spouse as the beneficiary. In that case, the fact that the one-year marriage rule is not satisfied is irrelevant. As the named beneficiary, the surviving spouse is entitled to the death benefit.

INTERACTION OF QPSA AND QJSA

Whether the QPSA or QJSA is payable depends on the time of the participant's death. If the participant dies before the **annuity starting date** (i.e., before benefits commence), then the preretirement death benefit rule is activated, and the QPSA must be provided unless a valid waiver was made. If the participant dies after the annuity starting date, the QJSA (or other optional form of payment elected by the participant and spouse) has commenced, and the QPSA is not applicable. In this latter situation, the spouse's benefit, if any, following the participant's death depends on the form of payment that commenced to the participant.

EXAMPLE 10-7. Participant Did Not Waive QPSA. D is a participant in a money purchase pension plan. At the time of D's death, D has not waived the QPSA benefit. The plan defines the QPSA as 50 percent of the vested account balance. P is D's surviving spouse. The plan must make a QPSA benefit available to P. If P does not elect to take a different form of payment, the QPSA must be paid as an annuity. Because the plan is a defined contribution plan, the administrator will purchase an annuity contract to provide those annuity payments. The contract will be purchased with 50 percent of the vested account balance. The other 50 percent is the non-QPSA death benefit (see below). The payment of the non-QPSA depends on the terms of the plan and the participant's beneficiary designation form, if any. P might also be the beneficiary of the non-QPSA portion.

Payment of Preretirement Death Benefits to Nonspouse Beneficiaries

A preretirement death benefit may be provided to a nonspouse beneficiary, as long as it does not cause the plan to fail the applicable death benefit requirements described above.

QPSA Applicable

If the QPSA is applicable, the first consideration is whether the QPSA has been waived, and the second consideration is how much of the benefit is payable under the QPSA rule.

If	Then
The QPSA has been waived	The preretirement death benefit is provided to the beneficiary named by the participant (to whom the spouse has consented as part of the waiver of the QPSA).
The QPSA has not been waived	There may be a portion of the participant's vested account balance that is not subject to the QPSA rule.

This is the non-QPSA portion of the preretirement death benefit. In a defined contribution plan, as little as 50 percent of the vested account balance may be applied to the QPSA. That leaves the rest for separate payment as a non-QPSA death benefit.

Beneficiary of the Non-QPSA Portion of Death Benefit

The beneficiary of a non-QPSA death benefit may be the spouse or another person or entity. The spouse does not have to be given consent rights over the beneficiary of a non-QPSA death benefit because the spouse's interest has been protected through the QPSA. Some plans will provide that the spouse must consent to a nonspouse beneficiary in all circumstances, even where the QPSA is not waived, but the law does not require such a provision. The terms of the plan will control the extent of the spouse's consent rights over the beneficiary designation.

Incidental Death Benefit Requirement

Preretirement death benefits must be incidental to the primary purpose of the plan—to provide retirement benefits.[43] If the QPSA is payable, the QPSA plus any additional death benefits must satisfy this **incidental death benefit requirement**.[44]

The total death benefit under a defined contribution plan (i.e., QPSA portion and non-QPSA portion) will never exceed the account balance, so the plan will always satisfy the incidental death benefit requirement (presuming that any life insurance purchased for the participant's account satisfies the incidental insurance limits). However, because the life insurance must be taken into account to value the QPSA, the plan should have the life insurance proceeds paid to the participant's account, and have the plan disburse the death benefits. This will ensure that the proceeds are not paid entirely as part of the non-QPSA death benefit where a portion of those proceeds may be needed to satisfy the QPSA liability to the surviving spouse.

Practical Effect of the QPSA Rules

Participants, and even many plan administrators, are often confused by the application of the QPSA rules and the practical effect on the payment of the death benefits. This is true particularly if the participant's sole primary beneficiary will be the participant's spouse anyway. If the

[43] Treas. Reg. §1.401-1(b)(1)(i).
[44] Rev. Rul. 85-15, 1985-1 C.B. 132.

participant wants to leave all of the death benefits (i.e., both the QPSA portion and the non-QPSA portion) to the surviving spouse, waiver of the QPSA is not a concern. The QPSA portion will be payable to the spouse anyway, and the non-QPSA portion will also be paid to the spouse because the beneficiary designation names the spouse as the beneficiary. The participant needs to be most concerned with the waiver of the QPSA when the participant wishes to have all or part of the QPSA portion of the preretirement death benefit payable to someone other than the participant's spouse. In that case, it is necessary to waive the QPSA benefit with the spouse's consent, and to have the spouse consent to the nonspouse beneficiary who will receive all or part of that QPSA portion of the death benefit.

Forfeiture upon Death

A plan may forfeit benefits (including vested account balances) upon the death of the participant.[45] This rule is subject to certain limitations, most importantly, the QPSA and spousal benefit requirements. If the QPSA rule applies, the plan may provide for forfeiture of the benefits other than those payable under the QPSA rule (i.e., only the non-QPSA portion of the death benefit, if any). If the spousal benefit rule applies, then benefits must be paid in full to the spouse, and no death benefit forfeiture is permitted.[46] Benefits attributable to an employee's elective deferrals under a 401(k) plan may not be forfeited upon death, even if the employee does not have a surviving spouse.[47]

Beneficiary's Consent to Immediate Distribution Not Required Except for Payment of QPSA

The general consent requirement under IRC §411(a)(11) regarding immediate distribution applies only to the participant, not to a death beneficiary, except for payment of the QPSA benefit.[48] Therefore, with the exception of the QPSA benefit, the plan may provide that death benefits are made in a particular form (e.g., lump sum) and at a certain time (e.g., as soon as administratively feasible following the participant's death), and consent of the beneficiary is not required to make the distribution, regardless of the value of the distribution.

Rollover Option for Surviving Spouse

If a death benefit distribution to a surviving spouse of a participant is in the form of an eligible rollover distribution, the **rollover notice** under IRC §402(f) is required. That means that a minimum 30-day election period must be provided during which the surviving spouse may consider the rollover option. Distribution could be made before the end of the 30-day period, only if the surviving spouse makes an affirmative election.

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[45] IRC §411(a)(3)(A); ERISA §203(a)(3)(A).
[46] Treas. Reg. §1.401(a)-20, A-13.
[47] Treas. Reg. §1.401(k)-1(c)(2).
[48] Treas. Reg. §1.411(a)-11(c)(5).

Transfer Option of Nonspouse Beneficiary

The death benefit may be transferred by the trustee of the qualified plan to an inherited IRA for the benefit of the nonspouse beneficiary. While a normal rollover IRA will be in the name of the beneficiary, an inherited IRA remains in the name of the deceased participant, but for the benefit of the beneficiary.[49]

The plan must make the nonspouse beneficiary rollover available to the beneficiary.[50] The nonspouse rollover must be effected through a trustee-to-trustee transfer of the funds to an inherited IRA; the 60-day rollover option is not available.[51] The rollover notice under IRC §402(f) must be provided to the nonspouse beneficiary as part of the distribution process.

Electronic Media for Making Beneficiary Designations

In IRS Notice 99-1, the IRS recognizes that electronic media may be used for making (or changing) beneficiary designations. However, electronic media for spousal consent is subject to certain restrictions (discussed later in this chapter).[52]

10.05: Postretirement Death Benefits

DEPENDENT ON FORM OF DISTRIBUTION SELECTED

A postretirement death benefit is paid only if the form of distribution that has commenced provides for payments after the participant's death.

QJSA

If payments commenced in the QJSA form, the postretirement death benefit is the survivor annuity payable to the spouse under that benefit. The survivor annuity is payable to the individual who was the participant's spouse at the annuity starting date, even if that individual is no longer married to the participant at the date of the participant's death.[53] A QDRO (see discussion below) may modify this rule.

Life Annuity

If the participant elected to receive a life annuity, there is no death benefit unless the life annuity was purchased from less than the participant's entire vested account.

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[49] IRC §402(c)(11).
[50] *Id.*; IRC §402(f)(2).
[51] Notice 2007-7, Q&A-15.
[52] Preamble to Treas. Reg. §1.411(a)-11(c), 65 F.R. 6001 (February 8, 2000).
[53] Treas. Reg. §1.401(a)-20, Q&A-25(b)(3).

Joint and Survivor Annuity (Other than QJSA)

Under a joint and survivor annuity other than the QJSA, the postretirement death benefit is the survivor annuity payable to the designated beneficiary under that benefit.

Annuity with Term Certain

If a life annuity includes a term certain, payments are guaranteed to continue through that term. If the participant dies before the guaranteed term ends, the postretirement death benefit is the payment for the remaining term certain. Similarly, if a joint and survivor annuity includes a term certain, the postretirement death benefit will include payments during the term certain if both the participant and the survivor annuitant die before the end of that guaranteed period.

Lump Sum Payout of Entire Benefit

If a participant receives a lump sum payment of the participant's entire account balance, and no further allocations are made after that distribution, there would be no postretirement death benefit.

SECURITY INTEREST FOR PARTICIPANT LOAN OUTSTANDING AT TIME OF DEATH

The participant may have an outstanding participant loan at the time of death. A participant loan is typically secured by the participant's vested account balance. Death of the participant usually triggers repayment of the loan by offsetting the account balance, pursuant to the security interest. The reduction of the account balance will not violate the QJSA or QPSA requirement, even though the reduction may affect the value of the QPSA or the value of the survivor annuity under the QJSA.[54]

EXAMPLE 10-8. Defined Contribution Plan. A participant's account balance at the time of the participant's death is $60,000. The participant is 100 percent vested in the account. The account consists of an outstanding loan balance of $8,000 and $52,000 worth of other investments. The plan reduces its liability to the participant's beneficiaries to $52,000 to take into account that $8,000 of the $60,000 had been disbursed to the participant as a loan and had not been paid back. If the QPSA requirement is applicable, then the value of the QPSA will be based on the $52,000 balance after the offset. Thus, if the QPSA is defined as a life annuity payable with 50 percent of the vested balance, then one-half of $52,000, or $26,000 (as adjusted for post-death earnings), is used to purchase the QPSA. Had the participant paid back the loan, there would be $60,000 available for distribution to the beneficiaries.

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[54] IRC §417(f)(5).

If the QJSA rules are applicable, the spouse must consent to the security interest at the time of the loan or the security interest is not valid.[55] The consent period is the 180-day period ending on the date of the loan, and the formalities discussed below for the spouse's consent to the QJSA or QPSA waiver apply.[56] If the value of the total account balance is $5,000 or less at the time of the loan, the spouse's consent is not required. The spousal consent rule does not apply unless the participant is subject to the QJSA or QPSA requirement.

10.06: Notice and Consent Rules

Certain notice and consent requirements will apply to plan distributions. Notice requirements relate to information the participant must receive before the distribution can be made. Consent requirements relate to whether the distribution can be made on an involuntary basis. Which notice and consent requirements apply will depend on whether the QJSA rule applies to the participant, and whether the participant's vested account balance exceeds a specified dollar amount (generally $5,000). These requirements apply any time a participant is electing to receive a distribution, even if the participant is electing an in-service distribution (including a hardship withdrawal), and even if the participant is electing to receive only a portion of his or her total vested account balance. The notice and consent rules described in this section are found primarily in IRC §411(a)(11) and IRC §417(e). They are requirements for plan qualification, by reason of the cross-referencing of these sections with IRC §§401(a)(7) and 401(a)(11).

Note that the same requirements are found in ERISA §203(e) (which parallels IRC §411(a)(11)) and ERISA §205 (which parallels IRC §417), so they are enforceable under Title I of ERISA as well. This discussion provides the IRC citations rather than the ERISA citations.

This discussion also relates solely to the circumstances under which the consent of the participant (and, in some cases, the participant's spouse) must be obtained, and the notices that must be provided before a distribution can be made. When the distribution is actually available is controlled by the terms of the plan, provided that the plan complies with certain legal restrictions on when distributions are available or required.

SOME INITIAL CONSIDERATIONS

Automatic Rollover Rules in Effect

IRC §401(a)(31)(B) requires that involuntary distributions in excess of $1,000 and less than $5,000 be automatically rolled over to an IRA in the absence of an affirmative election by the participant. This automatic rollover rule replaces the ability to cash out small amounts from the

[55] IRC §417(a)(4).
[56] Treas. Reg. §1.401(a)-20, A-24.

plan in lump sum payments. Involuntary cash-outs are available only for amounts up to $1,000, and only if the plan so permits.[57]

Multiple Investment Accounts

When a participant's account in a defined contribution plan is invested in multiple investments, a partial withdrawal may be made from the participant's account on a pro rata basis from each investment, or in some other fashion (e.g., by participant designation or through a default mechanism set forth in the plan). The plan document might be specific, in which case, the procedures set forth in the document should be followed. If the document is not specific, it is likely that the plan administrator or its designee will have to adopt a procedure pursuant to its general authority to interpret the plan document and administer the plan accordingly.

How a Spouse is Determined

The determination of who is a spouse is primarily a state law issue, although sometimes the federal courts must develop guidelines where state law does not resolve the issue. One particularly active issue in recent litigation has been the status of couples in same-sex marriages.

Recent Legal Developments

The Defense of Marriage Act[58] (DOMA), a federal law, defined marriage for purposes of federal law. Section 3 stated that a marriage, for federal law purposes, means only a legal union between one man and one woman as husband and wife, and the word spouse refers only to a person of the opposite-sex who is a husband or wife. However, on June 26, 2013, the Supreme Court, in *U.S. v Windsor,*[59] declared §3 of DOMA unconstitutional. Following *Windsor*, a same-sex marriage that is valid under a state's law, must also be recognized for federal law purposes, at least in such state.

In September of 2013, the IRS published Revenue Ruling 2013-17,[60] outlining its position that it recognizes any same-sex marriage for federal tax purposes, regardless of where the couple now resides. A legal same-sex marriage, for purposes of the tax code, is one that is validly performed in any jurisdiction that recognizes such marriages, regardless of whether the couple is domiciled in a state that recognizes same-sex marriages under the laws of that state.

The DOL confirmed in Technical Release 2013-04 that for purposes of ERISA, a same-sex couple is considered married if they were legally married in any state. This is true even if the couple now resides in a state that does not recognize same-sex marriage.

The IRS issued Notice 2014-19 clarifying that plans must be operated in accordance with the Windsor decision effective June 26, 2013.

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[57] DOL Reg. §2550.404a-2 (which creates a fiduciary safe harbor for the IRA rollover) and IRS Notice 2005-5.
[58] 1 U.S.C.A. §7, 28 U.S.C.A. §1738C.
[59] 133 S.Ct. 2675 (2013).
[60] IRB 2013-38.

The Windsor case did not affect §2 of DOMA, which provides that states do not need to recognize same-sex marriages performed in other states. The DOMA §2 question, however, was resolved exactly two years later. On June 26, 2015, the Supreme Court held in *Obergefell v. Hodges*[61] that all states must offer marriage licenses to same-sex couples, and that states must also recognize same-sex marriages validly performed in other states. (Note that although the *Obergefell* Court did not expressly reference DOMA §Section 2, the section cannot stand after the Court's holding that "there is no lawful basis for a State to refuse to recognize a lawful same-sex marriage performed in another State on the ground of its same-sex character."[62])

As of the publication of this text, the IRS has not yet issued a notice regarding impacts of the *Obergefell* decision on qualified plans. However, it seems likely that "spouse" for qualified plan purposes will mean a partner to a lawful marriage, regardless of whether the marriage involves same-sex or opposite-sex partners. Because the *Windsor* decision already included same-sex marriages for purposes of federal law, the plan implications in light of that decision are described below, and are expected to hold true.

Impact of *Windsor* on Qualified Plans

What effect did *Windsor* have on qualified plan? There were many issues affected by the decision. Briefly, lawfully wedded same-sex couples are treated the same as lawfully wedded opposite-sex couples for the following plan purposes:

- Beneficiary Designations. A participant who names someone other than his or her same-sex spouse as the primary beneficiary must obtain spousal consent.
- QJSAs and QPSAs. The QJSA and QPSA rules, as well as the profit-sharing exception to these rules, apply to same-sex couples. Thus, death benefits are paid to a same-sex spouse unless waived by the spouse. A QJSA must be paid to the spouse in plans to which the rules apply, unless the spouse waives the right to the benefit.
- Eligible Rollover Distributions. A same-sex spouse is allowed to elect a plan distribution and roll it over to his or her own IRA or to another qualified plan.
- Hardship Distributions. A same-sex couple is allowed a hardship distribution due to the participant's spouse's medical, tuition and/or funeral expenses.
- Minimum Required Distributions. A same-sex spouse is a spouse for purposes of minimum distribution requirements.
- QDROs. A same-sex spouse may be an alternate payee, and the tax consequences of receiving QDRO benefits are applied in the same manner as an opposite-sex former spouse who is an alternate payee.
- Loans/Spousal Consent. For a plan that requires spousal consent for a loan, the same-sex spouse's consent is required.
- ERISA Disclosures to Spouses. For any notice a plan must provide to an opposite-sex spouse, it must likewise provide it to a same-sex spouse.

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[61] No. 14-556 (U.S. June 26, 2015).
[62] *Id.*, slip op. at 28.

- Party-in-Interest/Disqualified Person Status. A same-sex spouse is considered a family member, just as an opposite-sex spouse, for purposes of determining whether a transaction is a prohibited one.
- Right to Bring Benefit Claims. A same-sex spouse has the right to apply for benefits as would an opposite-sex spouse.
- Family Attribution Rules. Attribution rules apply, and thus a same-sex spouse must be considered in determining highly compensated employee, key employee, controlled group and affiliated service group statuses.
- Prohibited Transaction Class Exemptions. A same-sex spouse is a spouse when determining whether the DOL prohibited transaction class exemptions apply.
- ERISA Definition of a One Participant Plan. A same-sex spouse is a spouse in determining whether one may file a Form 5500-EZ or is covered under Title I of ERISA.
- ESOP §1042 Transactions. A same-sex spouse is a spouse for purposes of allocating employer securities under an ESOP for the benefit of the seller's spouse or the spouse of a 25% or more shareholder.
- Non-Allocation Year for S Corporation ESOPs. A same-sex spouse is a spouse for purposes of ensuring no allocations are made to a disqualified person or family member (including the spouse) during a nonallocation year under IRC §409.

In light of the Court's recent rulings and IRS and DOL notices provided after Windsor, a same-sex spouse should be considered the same as an opposite-sex spouse for qualified plan purposes. The above are meant to illustrate the multitude of circumstances in which those considerations may apply.

GENERAL INFORMATION

IRC §§411(a)(11) and 417 outline notice and consent requirements that must be satisfied before a participant's benefits can be distributed. In addition, IRC §401(a)(31) requires a plan to give participants an opportunity to direct a rollover of an eligible rollover distribution, and to provide an automatic rollover to an IRA of amounts that are involuntarily distributable to the participant and are in excess of $1,000. IRC §402(f) prescribes notice requirements relating to the rollover rules and the tax consequences of not rolling over.

General Notice and Consent Requirements under IRC §§411(a)(11) and 417

Before a distribution can be made, the following must be provided to the participant:

- Written notice that explains the optional forms of payment available under the plan,
- Notice of the participant's right to delay payment until normal retirement age,
- Information about the direct rollover option and information on other tax issues.[63]

The contents of the written notice are explained in more detail below. In addition, the payment of

[63] Treas. Reg. §1.411(a)-11(c)(2).

a participant's benefit is not permitted until the participant provides written consent following receipt of the required notice, unless the plan is permitted to distribute such amounts involuntarily (whether as a cash distribution or an automatic rollover).[64] If the QJSA requirements apply to the plan, the spouse's consent is also required if the participant has elected to take distribution in a form other than the QJSA.[65] The consent requirements are discussed in more detail below.

Limited Notice and Consent Rules for Smaller Benefits (The Cash-out Limit)

If the value of the participant's vested account balance is $5,000 or less (referred to as the cash-out limit in the regulations), the QJSA rules are generally inapplicable, so the notice and consent requirements are more limited.[66] The plan may provide for distribution of the participant's benefits on an involuntary basis, even if the participant has not reached normal retirement age. This is known as an **involuntary distribution**. Consent to the distribution is not required from either the participant or the spouse.

Unless the participant elects otherwise, the participant's vested account balance will determine the method of distribution. If the participant's account is $1,000 or less, the plan may require that the account be distributed as a cash distribution, with applicable tax withholding. If the participant's account is between $1,000 and $5,000, an involuntary distribution is also permitted, although the funds must be rolled over to an IRA (as an automatic rollover), rather than paid out in cash to the participant.

Prior to making a distribution to a participant whose vested account balance does not exceed the cash-out limit, information about the automatic cash distribution and direct rollover options must be provided. In lieu of the automatic cash distribution or rollover, the participant may choose either form of distribution (cash or rollover to a plan or IRA of the participant's choice) for any amount in excess of $200 (the level below which there is no mandatory tax withholding). The exceptions for these smaller benefits are discussed in the context of the notice and consent rules below.

Mandatory Distributions under IRC §401(a)(9) and IRC §401(a)(14)

In some cases, the statute requires a plan to make distributions. IRC §401(a)(14) mandates certain commencement dates, none of which can occur prior to a participant's attainment of normal retirement age. In addition, IRC §401(a)(9) prescribes minimum distribution requirements to participants, which can occur as early as the calendar year in which a participant reaches age 70½.

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[64] Treas. Reg. §1.411(a)-11(c)(3).
[65] Treas. Reg. §1.417(e)-1(b).
[66] Treas. Reg. §1.411(a)-11(c)(3).

Distributions after the Death of a Participant

If benefits are being paid to a participant's beneficiary following the participant's death, the notice and consent rules generally do not apply, although certain notice and consent requirements are applicable with respect to the payment of benefits to a surviving spouse of the participant. The minimum distribution rules under IRC §401(a)(9) outline mandatory distribution requirements for death beneficiaries, depending on whether the participant dies before or after distributions otherwise are required to commence to the participant.

Qualified Domestic Relations Orders (QDROs)

If a QDRO is issued against the participant's account balance, pursuant to IRC §414(p) and ERISA §206(d), all or a portion of the account balance might be payable to an alternate payee, as identified in the QDRO. The alternate payee is usually the participant's former spouse, but it can also be a dependent of the participant. Limited notice and consent requirements apply with respect to QDRO distributions.

ESOPs and Stock Bonus Plans

The law provides for special distribution requirements for employee stock ownership plans (ESOPs) and stock bonus plans.

Plan Termination

When a plan terminates, there are special rules regarding the distribution of benefits and the notice and consent requirements with respect to such distributions.

Liability Issues

The plan administrator (or other responsible fiduciary) must prudently carry out the notice and consent requirements described below.

NOTICE REQUIREMENTS

The discussion below provides more detail on the notice requirements that must be satisfied before the plan may distribute benefits to a participant. Unless the involuntary distribution rules apply (i.e., unless the vested account balance is less than or equal to the cash-out limit), the participant must be provided with:

- An explanation of benefit payment options;
- Information about the right to delay distribution until at least normal retirement age; and
- The required IRS direct rollover notice.

Unless otherwise noted, the description below assumes that the distribution is in excess of the cash-out limit.

Explanation of Optional Forms of Payment

The participant must receive a written explanation of his or her distribution options. This includes the different forms of payment that are available and the relative values of each optional form of benefit.[67] The content of this notice will depend on whether the QJSA rule is applicable to the participant. If the QJSA rule does not apply, the forms of payment available under the plan will typically be a lump sum and installments, or only a lump sum.

If the QJSA rules apply to the participant, the explanation must include a description of the QJSA, the participant's right to waive the QJSA and elect a different form of payment, and the relative values of the optional forms of benefit.[68] The notice must also explain the spouse's consent rights regarding a waiver of the QJSA.

Right to Delay or Refuse Payment until Normal Retirement Age

IRC §411(a)(11)(A) states that the benefit cannot be immediately distributed without the participant's consent. Treas. Reg. §1.411(a)-11(c)(4) interprets "immediately distributed" to mean a distribution before normal retirement age. Therefore, if the participant has not reached normal retirement age, the notice must explain that the participant has the right to delay distribution.[69]

If the normal retirement age stated in the plan is earlier than age 62, the right to delay distribution must be protected until the participant reaches age 62, even though that date is later than normal retirement age. This can affect application of the mandatory commencement rule under IRC §401(a)(14).

Once the participant reaches normal retirement age (or age 62, if later), the plan is permitted to require that a distribution be taken. In that case, only the form of payment is left to the participant's election. The plan may permit the participant to postpone distribution beyond normal retirement age (or age 62, if later), subject to the minimum distribution requirements of IRC §401(a)(9). If the distribution cannot be delayed any longer, a written notice is still required, but the notice would explain only the payment options and the direct rollover option.

The ability to make a distribution pursuant to the participant's election is predicated on the fact that the participant has voluntarily elected a distribution. The consent is not treated as voluntary if there is a significant detriment to the participant's decision to postpone payment.[70]

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[67] Treas. Reg. §1.411(a)-11(c)(2).
[68] IRC §417(a)(3)(A), Treas. Reg. §1.401(a)-20, Q&A-36, and Treas. Reg. 1.417(a)(3)-1.
[69] Treas. Reg. §1.411(a)-11(c)(2).
[70] Treas. Reg. §1.411(a)-11(c)(2).

Direct Rollover Election

If the participant's distribution is an eligible rollover under IRC §402(c), or the participant has the option to elect a form of payment that will be in the form of an eligible rollover distribution, the plan must permit the participant to elect to have the amount directly rolled over to a permissible recipient plan.[71] A permissible recipient plan is another qualified plan, a 403(b) plan, a governmental 457(b) plan, an IRA or a Roth IRA.

Notice Requirement Under IRC §402(f)

IRC §402(f) requires the participant to receive a written explanation of the rollover option, the tax consequences of not making the rollover (e.g., mandatory income tax withholding) and, if applicable, any special income tax elections available (e.g., income averaging under IRC §402(d) for certain lump sum distributions). The notice requirement is sometimes referred to as the **402(f) notice** or the **special tax notice**. Because the primary focus of the notice is the participant's rollover rights, we refer to the notice as the **rollover notice**.

A sample notice is provided by the IRS in Notice 2018-74, which is intended to be a safe harbor explanation, meaning that use of the sample notice is deemed to be in compliance with IRC §402(f). There are two safe harbor explanations provided in Notice 2018-74:

1. The first explanation does not include information relevant to distributions from a designated Roth account, and should be used only for a distribution that is not from a designated Roth account.
2. The second explanation pertains to a distribution from a designated Roth account, and should be used only for such distributions. If an individual is a receiving a distribution that is only partly from a designated Roth account, the individual should receive both notices.

The safe harbor explanations in Notice 2018-74 are updated for all law changes through the publication date of that notice. The sample notice reflects language prescribed with respect to internal Roth conversions offered under a plan, the basis allocation rules for pre-tax and after-tax amounts, and to distributions in the form of Roth rollovers.

If the law governing the tax treatment of distributions or other provisions described in the sample notice provided in Notice 2018-74 is amended, the safe harbor explanation will not satisfy IRC §402(f), to the extent that the explanation no longer accurately describes the relevant law. Thus, plan administrators are required to update the safe harbor notice to reflect law changes that take effect in the future until the IRS issues an updated notice.

Periodic Payments that are Eligible for Rollover

A series of periodic payments in certain cases will constitute a series of eligible rollover distributions. For example, each payment under an installment distribution that is being made

[71] IRC §401(a)(31).

over a period of less than ten years would be an eligible rollover distribution. The plan may provide the employee with a separate rollover notice and election period with respect to each payment, or may treat an election for the first payment as applying to all subsequent payments unless the employee modifies the election.[72] If the latter approach is used, the plan must explain to the participant that an election to make or not to make a direct rollover will apply to all future payments unless the participant changes the election. The participant also must receive notice of these election rights at least annually during the term of the payments.[73]

Exception for Distributions Under $5,000

When an involuntary distribution or automatic rollover is made to a participant whose vested account balance is not in excess of the $5,000 cash-out limit, the direct rollover notice is required, even though the QJSA notice and consent information is not required. However, an exception applies for eligible rollover distributions of less than $200, for which a direct rollover option need not be provided.[74]

A plan may treat a participant's designated Roth account and a participant's non-Roth accounts as if they are in two separate plans for purposes of applying the rule in the prior paragraph.[75] For example, suppose a participant's Roth account is $150 and non-Roth accounts total $1,200. The plan would have to offer a direct rollover election with respect to the non-Roth accounts (and provide for automatic rollover in the absence of an affirmative election). However, the plan may treat the Roth account as part of a separate plan so that it would not have to offer a direct rollover (nor automatic rollover) with respect to the Roth account.

Penalty for Failure to Provide Notice

A penalty of $100 applies to a failure to give the direct rollover notice. There is a maximum penalty of $50,000 for all such failures in a calendar year.[76]

Using Direct Rollover as Default Distribution Method

A plan may have a default procedure whereby a participant who fails to make an affirmative election regarding the direct rollover is deemed to have requested a direct rollover to an IRA.[77] The plan administrator would establish an IRA on the participant's behalf to receive the rollover. Of course, if the participant's consent is required for distribution, then the direct rollover by default could occur only if the participant has consented to distribution in the form of an eligible rollover distribution, but simply has failed to specify whether a cash distribution is desired.[78]

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[72] Treas. Reg. §1.401(a)(31)-1, Q&A-12.
[73] Treas. Reg. §1.402(f)-1, Q&A-3.
[74] Treas. Reg. §1.401(a)(31)-1, Q&A-11.
[75] Treas. Reg. §1.401(k)-1(f)(4)(ii).
[76] IRC §6652(I).
[77] Treas. Reg. §1.401(a)(31)-1, Q&A-7.
[78] Notice 2000-36, 2002-2 C.B. 173.

The rollover notice must be provided no less than 30 days before the distribution. Thus, the participant must be given at least 30 days to make an affirmative election between the cash distribution and the direct rollover. Only after the expiration of this minimum election period may the plan proceed with the default rollover, and then only if the participant has otherwise consented to distribution, unless consent is not required.[79]

If You're Curious . . .

Issues Under Title I of ERISA

The IRS notes in Notice 2000-36 that the DOL would treat a plan administrator's decision with respect to the choice of the IRA trustee, custodian or issuer as a fiduciary action. When a plan makes an automatic rollover to an IRA, the fiduciary remains responsible until the earlier of:

- The date the participant takes control over the IRA; or
- One year after the benefit is transferred to the IRA.[80]

For this purpose, the participant is deemed to take control over the IRA if he or she makes investment decisions with respect to the IRA, or elects to transfer the funds to another IRA. There is an exception for involuntary cash-out distributions that are subject to the automatic rollover rule under IRC §401(a)(31)(B). Thus, for default rollovers that are not subject to that exception, the fiduciary retains liability with respect to the IRA for up to one year after the rollover occurs.

Pursuant to IRC §401(a)(31)(B), in the absence of an affirmative election by the participant to receive a distribution, involuntary cash-out distributions generally must be rolled over to an IRA. Regulations issued by the DOL provide fiduciary relief with respect to the implementation of such automatic rollovers.

Timing of Notice

The required notice described above must be given 30 to 180 days before the date the distribution commences.[81] Putting this rule into practice is not always easy. It is often not certain when the distribution will actually occur, nor what the form of payment will be. In practice, it is recommended to treat the date that the notice is actually given to a participant as representing the date which is theoretically 30 days before the date the distribution commences. That way, if the distribution is delayed, the actual distribution date can still occur up to an additional 150 days later without violating the 180-day maximum notice requirement. In addition, the distribution might occur earlier, pursuant to a participant election.

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[79] Treas. Reg. §1.402(f)-1, Q&A-2.
[80] ERISA §403(c)(3)(A).
[81] Treas. Reg. §1.411(a)-11(c)(2)(ii) (if QJSA rules do not apply) and Treas. Reg. §1.417(e)-1(b)(3) (if QJSA rules apply). See also Treas. Reg. §1.402(f)-1, Q&A-2, (providing for the same notice period with respect to the direct rollover notice).

If You're Curious . . .

The Distribution Commencement Date

The timing of the notice is determined with reference to the date the distribution commences. The form of payment is the determining factor of when a distribution is treated as commencing to the participant.

If the distribution is in the form of an annuity, such as a QJSA or a life annuity, the distribution commences on the date the first annuity payment is made. The notice period may, instead, be measured by reference to the annuity starting date. The annuity starting date is the first day of the first period for which the annuity is paid.[82] The annuity payments might not actually start on the annuity starting date. For example, an annuity might be payable monthly starting January 1st, but, due to administrative delays, the participant receives both the January and February payments with the February payment, and subsequent annuity payments every month thereafter. The annuity starting date would still be January 1st.[83]

If the annuity distributed from the plan is a deferred annuity contract—meaning the payments are not scheduled to start until a later date—the annuity starting date is the date when payments are scheduled to commence under the annuity contract. The notice and consent periods would be measured with reference to the scheduled annuity starting date under that contract, or, if earlier, the date the annuity payments actually commence. Thus, a plan is permitted, under certain circumstances, to distribute a deferred annuity contract to a participant without the participant's consent, because the participant's consent is not required until distribution commences under the annuity.

If the distribution is in the form of an installment payment, the distribution commences on the day the first installment payment is made. If the distribution is a nonperiodic payment, such as a lump-sum payment of all or part of the participant's benefit, the distribution commences on the date payment is made.

Reasonable Administrative Delay in Making a Distribution

If actual payment is postponed because of a reasonable delay in calculating the benefit amount, the payment is not considered to occur after the annuity starting date.[84] Treas. Reg. §1.411(a)-11(c)(2)(iv) permits the annuity starting date to be substituted for purposes of measuring the notice periods, even for distributions that are not in an annuity form. Where a reasonable delay in making payment has resulted in commencement of installments or distribution of a lump sum later than is permitted under the notice requirements, the plan administrator might invoke this exception. For example, this exception for reasonable administrative delay could cover an earnings trail that might be posted to a participant's account after distribution has been made.

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82 Treas. Reg. §1.401(a)-20, Q&A-10(b).
83 Treas. Reg. §1.401(a)-20, Q&A-10(b)(2).
84 Treas. Reg. §1.401(a)-20, Q&A-10(b)(3).

Failing to Distribute Within 180 Days After Notice is Given May Require Another Notice to the Participant

If the plan is unable to complete the distribution within 180 days of the date the notice is given, it is advisable to send another notice to the participant and start the process again. The IRS correction programs under the Employee Plans Compliance Resolution System (EPCRS) provide a means of correcting a failure to comply with the notice and consent requirements by obtaining retroactive consent from the participant (and spouse, if required) to a distribution that has occurred more than 180 days after the notice date.

One situation in which a distribution might occur after the 180-day period is when an earnings trail is posted to a participant's account after distribution has been made. The plan should be able to pay the final crediting of earnings even though the payment might be more than 180 days after the applicable distribution notices have been provided. (If the participant had elected a direct rollover of the entire distribution, the payment would be made to the plan or IRA that received the direct rollover.)

Allocation of Additional Contributions After the Distribution is Made

Suppose that subsequent to a distribution, the participant receives additional allocations of contributions or earnings under the plan. As a general rule, the original notice and distribution election probably do not cover distribution of that additional allocation, so the safer approach would be to send another notice to the participant. Under certain facts and circumstances, it may be appropriate to rely on the exception described above for administrative delay, or to analogize the situation to the earnings trail situation.

More Limited Notice Requirements for Vested Account Balance Not in Excess of the Cash-Out Limit

If the value of the participant's vested account balance is less than or equal to the cash-out limit, more limited notice requirements apply and the distribution of the participant's benefits may be made on an involuntary basis, eliminating the consent requirements described below (other than the 30-day election period requirement with respect to a rollover election). The plan may provide one of two options:

I. There is no involuntary distribution of vested account balances above $1,000, but amounts of $1,000 or less are automatically paid in the form of a cash distribution, subject to the expiration of the 30-to-180-day notice and election period. A plan may provide for a lower dollar amount that is automatically cashed out if the sponsor desires, such as $200 (the level below which there is no mandatory tax withholding); or
II. There is an automatic rollover for amounts between $1,000 and $5,000 (or all amounts below $5,000), and amounts of $1,000 or less are automatically paid in the form of a cash distribution, all subject to the expiration of the 30-to-180-day notice and election period. If the participant requests a distribution other than the

automatic rollover option, he or she is commonly limited to a distribution in one lump sum.

Timing of Distribution—Participant has No Right to Postpone

The right to postpone a distribution until normal retirement age does not apply here. Therefore, the plan can prescribe when the distribution or rollover will be made, and neither the consent of the participant nor the consent of the participant's spouse is required to follow through on that transaction. For example, the plan might state that the benefit is distributed or rolled over "as soon as administratively feasible after the participant terminates employment." The timing of an involuntary distribution or rollover must be specified in the plan document and cannot be left to the employer's discretion, although "as soon as administratively feasible" or similar language is permissible.[85]

Rollover Election Period is Applicable

The rollover notice must still be provided to a participant who is subject to this involuntary distribution rule, unless the total distribution is less than $200. Because Treas. Reg. §1.402(f)-1, Q&A-2 requires the same notice period for the rollover notice as for the distribution timing election, the rollover notice must be provided at least 30 days before and no earlier than 180 days before the involuntary distribution. A minimum 30-day notice period results in a minimum 30-day election period to decide whether to elect a direct rollover, so the plan may not actually make an involuntary distribution or rollover during the minimum 30-day election period, unless the participant makes an affirmative election to waive the remainder of that 30-day election period.

Lump-sum Distribution or Automatic Rollover is Permissible Even if QJSA Applies

The plan may require that the involuntary payment of the participant's vested account balance be in the form of a cash distribution (for amounts of $1,000 or less) or automatic rollover (for amounts between $1,000 and $5,000). This is true even if the QJSA rule applies under the plan. Neither the participant's consent nor the spouse's consent is required to pay the lump sum.[86] Although the distribution is involuntary, it cannot be paid until the period has passed for electing a direct rollover.

EXAMPLE 10-9. Automatic Rollover as Default Distribution. A company maintains a money purchase pension plan. As a pension plan, the plan is required to comply with the QJSA rule. The plan may provide that, if the participant's vested account balance does not exceed the cash-out limit, the benefit is paid in a cash distribution or automatic rollover, as appropriate, as soon as administratively feasible after the participant terminates employment. A QJSA does not have to be

[85] Treas. Reg. §1.411(d)-4, Q&A-4(a).
[86] IRC §417(e)(1).

made available to the participant. Neither the consent of the participant nor the consent of the participant's spouse is required.

A participant receiving more than $1,000 from the plan cannot have the distribution paid in cash, unless he or she makes an affirmative election.

Limited Notice Requirements for Involuntary Distributions

The only notice requirement with respect to the involuntary distribution is the rollover notice.

Summary Option Gives Administrators More Flexibility

The IRS allows for a summary of the distribution notice under Treas. Reg. §1.411(a)-11(c) to be provided during the normal 30-to-180-day notice period, as long as a complete notice has previously been provided to the participant.[87] Similarly, the plan administrator may provide the participant with a summary of the rollover notice, as long as a complete rollover notice has previously been provided to the participant.[88] This allows the complete notice to be given earlier than 180 days before the distribution date. For example, the complete distribution notice may be provided as part of the summary plan description (SPD). Then, at the time of the actual distribution, a summary is provided during the 30-to-180-day period.

The summary option allowed in the regulations is not available for notices required under IRC §417(e), relating to the QJSA. Therefore, if the participant must receive an explanation of the QJSA, the complete explanation must be provided within the 30-to-180-day period.

Contents of Summary

The summary must set forth the material provisions of the distribution notice. The summary must state that the participant has the right to defer receipt of the distribution (if applicable) and provide a brief description of the plan distribution options. The summary must set forth the material provisions of the rollover notice (i.e., the right to elect a direct rollover, the 20 percent withholding requirement for eligible distributions that are not directly rolled over, and the additional 10 percent tax on early distributions). A summary approach might be taken with just the IRC §411(a) (11) distribution notice requirements, with just the rollover notice requirements, or the plan might take the summary approach with both requirements.

Reference to Full Summary

The summary must refer to the most recent version of the full notice that was provided. If more than one version of the full notice has been distributed, a reference to the year (or month, if more than one version was distributed in the same year) is usually sufficient. Reference to the month or year would not be necessary if only one version has been distributed. If the full notice is always available (e.g., on a plan website), that fact could be referenced in the summary. If the

[87] Treas. Reg. §1.411(a)-11(c)(2)(iii)(B).
[88] Treas. Reg. §1.402(f)-1, Q&A-2(b).

full notice is in another document (such as the SPD), the summary must provide a reasonable indication of where the notice may be found in that document, such as by index reference or by section heading.

No Need for Periodic Delivery of Full Notice

The full notice need not be provided on a regular periodic basis. For example, the full notice might be given only when the SPD (or amended SPD) is distributed. However, the contents of the full notice must be updated (and provided to the participant) as necessary to ensure accuracy as of the time the summary is provided.

Availability of Full Notice

When a summary is provided within the 30-to-180-day notice period, the summary must state that, upon request, a copy of the full notice will be provided at no charge.

Electronic Delivery of Summary

If the summary is given through an electronic medium, the same standards for electronic delivery that apply to the full notice are also applicable to the summary. In addition, the participant must be able to request a written paper copy of the complete notice at no charge.

CONSENT REQUIREMENTS

When the vested account balance exceeds the cash-out limit, commencement of the benefit payment is not permitted until the participant provides written consent following receipt of the required notice.[89] The participant's consent must cover the form of payment being elected (unless there is only one form of payment available under the plan) and, if applicable, the consent must cover the payment of the distribution before the participant's normal retirement age (or age 62, if later). This is true regardless of whether the QJSA rule applies under the plan. If the QJSA rule applies, the spouse's consent is also required if the participant has elected to take distribution in a form other than the QJSA. In addition, the participant must formally waive the QJSA to receive an alternate form of payment, even if the participant is unmarried. The participant's consent to distribution (and the spouse's consent, if applicable, though only in limited circumstances described below) may be provided through electronic media.

As previously noted, the participant's consent to commence distribution may not be required if his or her vested account balance exceeds the cash-out limit solely because of a rollover account. (The plan document, however, may require consent regardless of this rule.)

QJSA Waiver

If the QJSA rule applies to the participant, the form of payment must be a QJSA, unless the participant waives the QJSA and elects a different form of payment.[90] A married participant's

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[89] Treas. Reg. §1.411(a)-11(c)(3).
[90] IRC §417.

waiver is not valid unless the participant's spouse also consents to the waiver and the alternate distribution election. No waiver is required for the participant to elect the QOSA form of benefit.

An opportunity to waive the QJSA is not required if the benefit is fully subsidized.[91] In a defined contribution plan, the QJSA, unlike the QPSA, is not subsidized unless it is the only form of payment available to the participant. It is unusual to see a defined contribution plan that is written with the QJSA as the only payment method, so the waiver option will usually have to be available under a defined contribution plan.

As discussed above, non-pension plans (i.e., profit-sharing plans and stock bonus plans) are not required to provide the QJSA method of payment if the exception under IRC §401(a)(11)(B) is satisfied.

Spousal Consent to QJSA Waiver

Spousal consent to a QJSA waiver must:

- Be in writing;
- Acknowledge the effect of the participant's election; and
- Be witnessed by either a notary public or plan representative.[92]

Spousal consent is not required to make a direct rollover of non-Roth funds into a designated Roth account under the plan via an internal Roth conversion.[93]

The use of electronic media will satisfy the written waiver requirement, but only if the spouse has consented in person before a notary public or plan representative. In *Lasche v. George W. Lasche Basic Profit Sharing Plan*,[94] the Eleventh circuit held that the spousal consent is invalid as a matter of law if there is no signature by a notary or plan representative, even if the spouse acknowledges signing the form. Treasury regulations permit electronic consent and notarization, if possible.[95]

The spouse's waiver is not valid unless the spouse has consented to the alternative form of payment elected, and, if applicable, to any nonspouse beneficiary designated to receive payments in the event of the participant's death before the distribution is completed. The plan may provide that the spouse's consent is irrevocable (unless the participant modifies the election).[96]

The spouse may be permitted to give a **blanket consent**, under which the spouse consents to any form of payment and/ or beneficiary that the participant designates.[97] A blanket consent is not valid unless the spouse acknowledges that he or she has the right to limit the consent to a specific

[91] IRC §417(a)(5); Treas. Reg. §1.401(a)-20, Q&A-38.
[92] IRC §417(a)(2)(A).
[93] Notice 2010-84, Q&A-3.
[94] 111 F.3d 863 (11th Cir. 1997).
[95] Treas. Reg. §1.401(a)-21(d)(6).
[96] Treas. Reg. §1.401(a)-20, Q&A-30.
[97] Treas. Reg. §1.401(a)-20, Q&A-31(c).

form of payment and/or beneficiary. Sample notice and consent forms that explain the spouse's rights are published in IRS Notice 97-10.

Exceptions to Spousal Consent Requirement

If it is established that there is no spouse, or that the spouse cannot be located, spousal consent is not required.[98] No consent is required if there is a court order that the participant is legally separated from the spouse, or that the participant has been abandoned by the spouse. If the spouse is not legally competent to give consent, the spouse's legal guardian may give consent, even if the guardian is the plan participant.[99]

Spousal Consent Not Required if QJSA is Elected

The spouse's consent is not required if the benefits are payable in the QJSA form, even if the QJSA will commence before the participant reaches normal retirement age.[100]

One-year Marriage Rule

The plan may require the participant and spouse to be married for at least one year as of the annuity starting date for the QJSA to be applicable.[101]

If You're Curious . . .

Consent to Distribution Must Be Voluntary

A participant's consent to a distribution must be given voluntarily. In this regard, the regulations treat a participant's consent as not being voluntary if there is a **significant detriment** to the participant's decision to postpone payment.[102] If the participant's consent is tainted, any distribution pursuant to such consent potentially disqualifies the plan. Whether there is a significant detriment imposed on a participant for choosing to postpone distribution is determined under all facts and circumstances. In its audit guidelines proposed in Announcement 95-33, the IRS discusses the significant detriment issue and discusses the three issues described below.

Significant Detriment: Restricted Investment Options

An example of a significant detriment is a provision in the plan which requires the investment of the participant's account in limited, less profitable investments than are available while the participant was an employee.

Significant Detriment: Long Wait for Another Distribution Opportunity

Another example of a significant detriment is a plan provision that requires a participant to wait until after normal retirement age for the next opportunity to elect a distribution if

[98] IRC §417(a)(2)(B).
[99] Treas. Reg. §1.401(a)-20, Q&A-27.
[100] Treas. Reg. §1.417(e)-1(b)(1).
[101] IRC §417(d).
[102] Treas. Reg. §1.411(a)-11(c)(2).

the participant fails to elect a distribution at the time he or she terminates employment. In other words, if a distribution is available to the participant when he or she terminates, but the participant elects to postpone distribution, there must also be a reasonable frequency with which the participant has the right to change his or her mind and elect a distribution during the period between the initial termination of employment and the participant's attainment of normal retirement age.

The issue described in the prior paragraph is not raised if a participant has no right to elect distribution until after reaching normal retirement age. In this latter case, the participant is not being asked to choose between immediate distribution (e.g., upon termination of employment) or postponement for a potentially significant period of time (e.g., normal retirement age). If a participant must wait until normal retirement age as the earliest date he or she can elect a distribution, with no immediate distribution available following termination prior to normal retirement age (other than involuntary distribution of benefits that do not exceed the cash-out limit), there is no significant detriment because there is no participant consent involved in the postponement of distribution to normal retirement age. In fact, IRC §401(a)(14) permits a plan to prohibit distribution before normal retirement age.

Significant Detriment: Reduced Distribution Availability for Former Employees

A third example of a significant detriment is limiting certain distribution options only to active participants, even if former employees otherwise satisfy the conditions for distribution.

Requiring Former Employees to Pay Their Share of Administrative Expenses is Not a Significant Detriment

Suppose the plan requires former employees to bear the administrative expenses attributable to their account balances, even though the employer pays such expenses for active employees. Would that violate the significant detriment rule? The IRS concluded that this disparate treatment in the payment of administrative expenses is not a significant detriment because analogous fees would be imposed in the marketplace, either implicitly or explicitly, for comparable investments outside of the plan.[103]

ELECTION AND CONSENT TIMING

Participant's Election May Not Be More than 180 Days before the Distribution Date

The participant's consent to distribution, which is evidenced by the distribution election, must be made no earlier than 180 days before the distribution commencement date.[104] Some plan administrators fail to take this requirement seriously, and make distributions more than 180 days after the notice period commences, but the issue has actually been litigated. For example, in

[103] Rev. Rul. 2004-10, IRB 2004-7.
[104] Treas. Reg. §1.411(a)-11(c)(2)(ii) and §1.417(e)-1(b)(3).

Jacobs v. Reed College TIAA-CREF Retirement Plan,[105] a QJSA waiver was held invalid since the participant's election occurred more than 90 days before the distribution date. (The ruling was issued when the maximum notice period was 90 days, rather than 180 days.) This maximum election period applies regardless of whether the QJSA rule applies. The maximum election period coordinates with the maximum notice period.

Minimum 30-day Election Period

Because the participant must receive notice before an election can be made, and the notice can be made no later than 30 days before the date the distribution commences, the participant's minimum election period must be 30 days. For example, if notice is given on January 15, the participant's election period must not end earlier than February 14. The Treasury has formulated this 30-day minimum election period to provide the participant (and the spouse, if applicable) a sufficient amount of time to consider the benefit payment options, or whether to commence distribution at that time. In addition, the participant will consider during this period whether to elect a direct rollover if payment is to be made in the form of an eligible rollover distribution (e.g., as a single-sum payment). This period also provides the participant a minimum amount of time to reconsider an election.

Waiver of 30-Day Period Permitted Under Certain Circumstances

The participant may waive the 30-day minimum election period by making an affirmative election.[106] The affirmative election may be in the form of a request for distribution in a specified form, or a request for a direct rollover of the distribution to another plan or to an IRA. The participant must acknowledge, in writing, that a minimum 30 days is available and that the period is being waived, in order for the distribution (whether as cash or as a rollover) to be made before the end of the minimum 30-day election period. How quickly the plan may pay the distribution following an affirmative election depends on whether the QJSA rule applies to the account.

Timing of Distribution If QJSA Rule Does Not Apply

If the QJSA rule does not apply to the participant, the distribution (or rollover) may occur as soon as administratively feasible following the plan's receipt of the affirmative election, even if the 30-day minimum election period has not expired at the time of the distribution (or rollover).

Timing of Distribution If QJSA Rule Applies

If the QJSA applies to the participant, the distribution (or rollover) may occur as soon as administratively feasible, even if the 30-day minimum election period has not expired, but not until seven days have elapsed since the notice was provided to the participant.[107] For example, if

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[105] 12 EBC 2828 (D. Ore. 1990).
[106] Treas. Reg. §1.411(a)-11(c)(2)(iii) and §1.417(e)-1(b)(3)(ii), regarding the election requirements under IRC §§411(a)(11) and 417(e), and Treas. Reg. §1.402(f)-1,Q&A-2(a), regarding the direct rollover election.
[107] IRC §417(a)(7)(A) and Treas. Reg. §1.417(e)-1(b)(3)(ii)(D).

notice is given to the participant on July 1st, no distribution may be made between July 2nd and July 8th, which is the seven-day period following the date of the notice. However, a distribution could be made any time after July 8th, if the participant has made an affirmative election. This timing rule applies regardless of whether the participant is electing to take a distribution in the QJSA form or in a different form. Note that the seven-day period described in this paragraph is measured with reference to the date the notice was given to the participant, not the date the plan receives the affirmative election from the participant to commence benefits.

Annuity Starting Date May Precede Election and Written Explanation of Distribution Options

If an annuity form of payment is elected by the participant, the annuity starting date does not have to be after the date of the participant's election.[108] In addition, the annuity starting date does not have to be after the date the written explanation of the QJSA is provided to the participant.[109] However, if the annuity starting date is before the participant makes his or her election (or before the participant receives the explanation), the plan may not make any annuity payments to the participant within the seven-day period described in the prior paragraph, even if an affirmative election has been made by the participant.

For example, suppose a participant elects to commence a QJSA with an annuity starting date of February 1st. The election is made on February 15th. The first annuity payment could not be made before February 23rd (i.e., at the expirations of the seven-day period), even though the payment made at that time is based on a February 1st annuity starting date.

EXAMPLE 10-10. QJSA Rule Does Not Apply. J, age 40, is a participant in a 401(k) plan. J's vested account balance is $6,000. The QJSA rule does not apply because the 401(k) plan satisfies the exemption requirements under IRC §401(a)(11)(B). On April 10th, J receives notice of J's election rights and right to delay distribution to normal retirement age. J also receives the rollover notice. On April 16th, J files an election for a lump-sum cash distribution. The election acknowledges J's right to a minimum 30-day election period, and specifically waives the remaining period. The lump-sum payment may be made at any time following receipt of the election on April 16th (even by close-of-business on April 16th). In addition, if J had elected a direct rollover of all or part of that lump-sum payment, the rollover could be completed at any time after the election is received.

EXAMPLE 10-11. QJSA Rule Applies. N is a participant in a 401(k) plan that does not satisfy the exemption requirements under IRC §401(a)(11)(B). The QJSA rule therefore applies to distributions from the plan, and the QJSA is the

[108] Treas. Reg. §1.417(e)-1(b)(3)(ii)(C).
[109] IRC §417(a)(7)(A).

default method of payment, unless a QJSA waiver (with spousal consent) is made and an alternative form of payment is elected. On September 19th, N receives notice of N's distribution rights, including an explanation of the QJSA and the spousal consent requirements. On September 22nd, N elects to waive the QJSA and requests a lump sum cash distribution. N's spouse consents to the election and the spousal consent is witnessed by a notary public. N's affirmative election to take the lump sum distribution may waive the 30-day minimum election period, but no distribution may be made before September 27th, which is the first day following the expiration of the seven-day period following N's notice date, even if the plan has the ability to pay the lump sum sooner. In addition, if N had elected a direct rollover of all or part of that lump sum payment, the rollover could not be completed earlier than September 27th.

EXPLANATION OF QJSA

The QJSA explanation must contain, with respect to each of the optional forms of benefit presently available to the participant, the following information:

- A description of the optional form of benefit;
- The eligibility conditions for the optional form of benefit (e.g., a minimum age or minimum service condition for a subsidized early retirement benefit);
- The financial effect of electing the optional form of benefit;
- The relative value of the optional form of benefit compared to the value of the QJSA; and
- Any other material features of the optional form of benefit.[110]

If the plan is a defined contribution plan, the financial effect described above must include a statement that the annuity will be provided by purchasing an annuity contract from an insurance company with the participant's account balance.[111] Also, the QJSA explanation could be made by either:

I. Providing the participant with information specific to the participant (the participant-specific method), or
II. Providing generally applicable information (the generalized notice method) and offering the participant the opportunity to request additional information specifically applicable to the participant with respect to any available optional form of benefit.[112]

EXPLANATION OF QPSA

The QPSA explanation must contain:

- A general description of the QPSA;

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[110] Treas. Reg. §1.417(a)(3)-1(c)(1).
[111] Treas. Reg. §1.417(a)(3)-1(c)(4).
[112] Treas. Reg. §1.417(a)(3)-1(d).

- The circumstances under which it will be paid if elected;
- The availability of the election of the QPSA; and
- If applicable, the financial effect of the election of the QPSA on the participant's benefits (i.e., an estimate of the reduction of the participant's estimated normal retirement benefit that would result from an election of the QPSA).[113]

The information referenced in the last bullet may be provided through a general description (e.g., in the form of a chart showing the reduction at a representative range of participant ages), accompanied with a statement that the participant may request an estimate of the reduction to the participant's estimated normal retirement benefit.[114] If the plan does not reduce the normal retirement benefit because of a QPSA election, then the information referenced in the last bullet is not required.

ADDITIONAL INFORMATION IS ENCOURAGED

The regulations encourage plans to provide additional information in a QJSA or QPSA explanation that goes beyond the minimum required information in order to help a participant evaluate the form of benefit that would be most desirable under the participant's individual circumstances. For example, the plan might wish to add further explanation of the effects of ill health or other factors influencing expected longevity on the desirability of electing annuity forms of distribution.

METHOD OF DELIVERY

The QJSA and QPSA explanations must be written explanations. Acceptable methods of delivery are:

- First class mail to the last known address of the participant; or
- Hand delivery.

Posting at the worksite is not an acceptable method.[115] Treasury regulations allow the QJSA explanation to be provided through electronic media.[116] The regulations take into account the effect of the Electronic Signatures in Global and National Commerce Act (E-SIGN).[117]

If You're Curious . . .

Paperless Transactions

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[113] Treas. Reg. §1.417(a)(3)-1(b)(1).
[114] Treas. Reg. §1.417(a)(3)-1(d)(3).
[115] Treas. Reg. §1.417(a)(3)-1(a)(3).
[116] Treas. Reg. §1.401(a)-21.
[117] Pub. L. 106-229, 114 Stat. 464 (2000).

Treas. Reg. §1.401(a)-21 sets uniform rules regarding the use of electronic media to provide notices to participants and beneficiaries, or to accept elections or consents relating to employee benefit arrangements, including consents by spouses to certain distribution or loan transactions. The regulations also incorporate the provisions of E-SIGN. The rules apply to all IRC requirements regarding these issues, as well as the provisions of ERISA that parallel such IRC requirements.

Timing of Notice When it is Provided Continuously

When employees have access to the distribution notices through electronic means, practitioners have argued that the notice is provided on a continuous basis, thus alleviating the need to count the 30-and 180-day notice and election periods described above from a date earlier than the participant's actual execution of the form. In other words, the participant may be deemed to have received notice as of the date the distribution election is signed, so the plan has 180 days from the execution date to complete the distribution without having to send another notice to the participant. Neither the Treasury nor the IRS has spoken directly on this issue through formal guidance.

Style of Electronic Notice

An electronic notice must be designed in a manner that is no less understandable to the participant than a written paper document.[118] An electronic medium that is similar to a written document, such as an e-mail or a plan website, would satisfy this requirement in most cases. But an oral-only delivery, such as an automated telephone system, might not satisfy this requirement. In addition, depending on the complexity of the distribution options in the plan, oral delivery may not be appropriate for the distribution notice required under IRC §411(a)(11). To this end, the regulations create a summary notice option that could be delivered through an oral medium, with the complete notice available through a written paper document.

An electronic communication must alert the recipient of the significance of the transmittal and provide instructions needed to access the notice in a manner that is readily understandable and accessible.[119]

Where a plan provides notice by electronic means, the participant must have the right to request a written paper copy at no charge.[120] The participant must be advised at the time electronic notice is given of the right to make such a request. The request for a paper copy could be made electronically. This requirement is not satisfied merely because an electronic medium (e.g., a plan website) has a print option for printing out the notice, since there is uncertainty in determining whether a participant will, in fact, be able to generate the paper version of the notice.

Electronic Consent to Distribution by Participant is Permitted

The regulations outline rules for obtaining a participant's consent to a distribution through electronic means.[121]

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[118] Treas. Reg. §1.401(a)-21(a)(5)(i).
[119] Treas. Reg. §1.401(a)-21(a)(5)(ii).
[120] Treas. Reg. §§1.401(a)-21(b)(3)(i), 1.411(a)-11(f)(1)(ii), and 1.402(f)-1, Q&A-5(b).
[121] Treas. Reg. §§1.401(a)-21, 1.411(a)-11(f)(2).

Confirmation of Consent

If consent is given electronically, the participant must receive confirmation within a reasonable time after consent has been given.[122] The confirmation may be delivered through an electronic medium.

If the confirmation is delivered electronically, the participant must be able to request a written paper confirmation (at no charge). Confirmation does not have to be provided at a separate time. For example, a plan's website could confirm the transaction immediately before completion of the session.

Security

An electronic system for participant consent must be reasonably designed to preclude someone other than the participant from giving the consent (e.g., the use of a password or PIN).[123]

Right to Confirm, Modify or Rescind

Before electronic consent to distribution can become effective, the participant must have an opportunity to review the election, and to confirm, modify or rescind the terms of the distribution.[124] There need not be a mandatory rescission period after the transaction is completed, so long as there is an opportunity before the participant completes the electronic session to rescind the request. (The IRS compares this to written paper forms, where the participant has the opportunity to review the election form before submitting it to the plan.)

Examples of electronic administration of the above notice and consent requirements are provided in the regulations.[125] There is an example for each of three types of electronic media: e-mail, plan website and automated telephone system. The examples are not intended to limit the electronic medium that is used. The regulations, in fact, take a very general approach, focusing on standards that protect the participants and ensure receipt of information, rather than on specific characteristics of each electronic medium. This will enable the regulations to accommodate future developments in electronic media.

Recordkeeping Issues

The IRS has issued guidance on electronic recordkeeping which applies to retirement plans, employee benefit plans and IRAs. Rev. Proc. 98-25 specifies the basic requirements that the IRS considers essential when records are maintained within an automatic data processing system. Rev. Proc. 97-22 provides guidance on maintaining books and records by using an electronic storage system that captures images of hardcopy books and records or transfers computerized books and records to an electronic storage medium (e.g., optical disk). Both procedures include language that expressly makes them applicable to employee plans. Treasury regulations have also been issued that discuss the recordkeeping requirements for electronic notice and consent.[126]

[122] Treas. Reg. §§1.401(a)-21(d)(5); 1.411(a)-11(f)(2)(iii).
[123] Treas. Reg. §§1.401(a)-21(d)(3); 1.411(a)-11(f)(2)(I) and (g) (Example 1).
[124] Treas. Reg. §§1.401(a)-21(d)(4); 1.411(a)-11(f)(2)(ii).
[125] Treas. Reg. §1.402(f)-1, Q&A-6, and §1.411(a)-11(g).
[126] Treas. Reg. §1.401(a)-21(a)(3)(ii).

NOTICE AND CONSENT RULES APPLY TO PARTIAL WITHDRAWALS

The notice and consent requirements apply only to the portion of the benefit being distributed. Usually, a participant's distribution election covers the entire vested account balance, even if payment will be spread out over a period of time, such as the participant's life or a specified installment period. However, a participant might elect to take a distribution of only a portion of the vested account balance. For example, under a profit-sharing plan, the participant might be allowed to make a hardship withdrawal while still working for the employer. Where the distribution relates only to a portion of the account balance, the consent given by the participant (and the spouse, if the QJSA rule applies) covers only that distributed amount. When the participant later elects another distribution, separate notice and consent requirements are applicable.[127]

Additional Allocations

If the distribution occurs while the participant is still employed, additional allocations of contributions or earnings may be made after the date the distribution commences. If that date occurs after the participant's normal retirement age, the distribution date is deemed to apply to the additional allocations.[128] In that case, the optional form of benefit elected by the participant would be applied automatically to the additional allocations. The plan may provide a different rule. For example, it may apply separate notice and consent requirements to the distribution of the additional allocations. This rule is helpful particularly with respect to participants who are subject to the QJSA rule when minimum distributions are required to commence under IRC §401(a)(9).

Application of Notice and Consent Rights Based on Value of Entire Vested Account Balance

If a participant is electing to withdraw only a portion of his or her total vested account balance, but the value of the total vested account balance exceeds the cash-out limit, the full array of notice consent requirements are applicable, even if the amount being withdrawn is less than the cash-out limit.

EXAMPLE 10-12. Determination of Notice Rules for Partial Distribution. D is a participant in a profit-sharing plan that permits in-service withdrawals once an employee has reached age 50. D is 55 years old and has a vested account balance in the plan of $18,000. D wishes to withdraw $2,000 from D's account, pursuant to the plan's in-service withdrawal provision. Even though D is withdrawing less than $5,000, the notice and consent rules apply to D's withdrawal because D's total vested account balance exceeds the cash-out limit ($5,000) at the time of the

[127] Treas. Reg. §1.401(a)-20, Q&A-9 and §1.411(a)-11.
[128] Treas. Reg. §1.401(a)-20, Q&A-10(d)(2).

withdrawal. Thus, D must receive a notice explaining D's payment options with respect to the in-service withdrawal, the right to delay distribution, the QJSA explanation (if applicable under the plan), and the rollover notice.

ABSENCE OF PARTICIPANT ELECTION WHERE PARTICIPANT'S CONSENT TO DISTRIBUTION IS REQUIRED BEFORE DISTRIBUTION CAN BE MADE

If the participant does not make an election to receive a distribution, but the value of the participant's vested account balance exceeds the cash-out limit, when and in what form will the plan make a distribution?

No Distribution is Permitted Before Normal Retirement Age Without Participant's Consent

As discussed above, the plan cannot force a distribution before the participant reaches normal retirement age (or age 62, if later), except for benefits that are subject to involuntary cash-out.[129] The plan may provide that, in the absence of an election, distribution will commence at that later time. In the interim, if the plan permits the participant to elect to commence distribution at other times, those other options must continue to be available to the participant. A new notice and consent period will have to be measured with respect to the postponed date of distribution.

Distribution is Elected But No Formal Election Regarding Direct Rollover is Made

If the participant has affirmatively elected to take a distribution, and the payment method elected is in the form that constitutes an eligible rollover distribution (e.g., a lump sum payment), but the participant has not made an affirmative election whether to roll over the distribution pursuant to the direct rollover option explained in the rollover notice, the plan can presume that the participant is not electing a direct rollover and proceed with the distribution to the participant.[130] However, any payment of the distribution must not occur before the expiration of the minimum 30-day election period. Many plans combine the distribution election form with the rollover election form, so when the participant submits an election for distribution, an election regarding whether to roll over is included.

DEFAULT FORM OF PAYMENT WHEN CONSENT IS NO LONGER REQUIRED

Once the distribution can be made without the participant's consent (i.e., after the later of normal retirement age or age 62), in what form will the plan make that distribution? A default form of payment must be prescribed in the event the participant does not elect an available option in a

[129] *Franklin v. Thornton*, 983 F.2d. 939 (9th Cir. 1993).
[130] Treas. Reg. §1.401(a)(31)-1, Q&A-7 (allowing the plan administrator to adopt a default procedure for participants who fail to make an affirmative election regarding whether to rollover).

timely manner. If the QJSA rule applies, this form of payment must be a QJSA unless, before the distribution commences, the participant waives the QJSA (with spousal consent) and elects an alternative form of payment. If the QJSA rule does not apply, the form of payment will be the form specified in the plan (usually a lump sum), unless an alternative form of payment is elected by the participant.

When a forced distribution is allowed, the participant must be given one final notice and election period. During this final notice and election period, the participant may choose the form of payment (if the plan offers more than one payment method) and whether to direct a rollover (if applicable) before the default form of payment is made.

A plan may have a default procedure whereby a participant who fails to make an affirmative election regarding the direct rollover is deemed to have requested a direct rollover to an IRA.[131]

Delay in Participant's Election

Suppose the participant elects a distribution, but that election is not given to the plan until more than 180 days after the distribution notice is given. Once the 180-day maximum notice period passes, the administrator should consider the absence of an election as a default election to delay payment until the time at which, pursuant to IRC §411(a)(11), an involuntary distribution can be made (i.e., not before the later of normal retirement age or age 62). When an election to take distribution is later received, the plan should re-notice the participant. For a distribution to be made less than 30 days after the re-notice date, the participant would have to waive the new 30-day election period.

Vested Account Balance Not Exceeding the Cash-out Limit: Failure to Make Rollover Election

If the value of the participant's entire vested account balance does not exceed the cash-out limit, and the plan provides for an involuntary distribution of such benefits, the participant's election is not needed to proceed with the distribution.

MANDATORY DEFAULT ROLLOVER PROCEDURE FOR CERTAIN INVOLUNTARY DISTRIBUTIONS

IRC §401(a)(31)(B) requires that a direct rollover to an IRA be the default method of payment for involuntary cash-out distributions exceeding $1,000. However, a participant may affirmatively elect to receive cash or affirmatively elect to have the distribution directly rolled over to an IRA of the participant's choosing.[132]

The IRS requires, either with or separate from the IRC §402(f) notice, that the plan administrator notify the participant that, in the absence of an affirmative election, an automatic rollover will be made.[133] This notice may be sent to the last known address of the participant, and the plan is not

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[131] Treas. Reg. §1.401(a)(31)-1, Q&A-7.
[132] DOL Reg. §2550.404a-2.
[133] Notice 2005-5, IRB 2005-3, Q&A-15.

treated as failing to meet this requirement even if the notice is returned as undeliverable by the U.S. Postal Service. In addition, IRC §401(a)(31)(B)(i) requires the plan to notify the participant that the automatic rollover has been made and that the participant has the right to transfer the funds to a different IRA.

What Distributions are Subject to this Rule

Only mandatory distributions described in IRC §401(a)(31)(B) are subject to the automatic rollover rules. A mandatory distribution is a distribution of a participant's vested account balance that:

- Can be made without obtaining the consent of the participant, pursuant to IRC §411(a)(11) (often called involuntary cash-out distributions);
- Has a value exceeding $1,000; and
- Is made before the participant attains the later of age 62 or normal retirement age.

However, the DOL's fiduciary safe harbor is also available to mandatory distributions of less than $1,000 for plans that choose to apply the automatic rollover rule to these smaller distributions as well.

Distributions in Excess of $5,000 Because of Rollover Contributions

A plan may disregard the portion of a participant's vested account balance which is attributable to a rollover contribution when determining whether the value of the vested account balance exceeds the involuntary cash-out threshold of $5,000.[134] If the plan has adopted this rule and the value of a participant's vested account balance does not exceed the plan's involuntary cash-out limit when the amount attributable to rollover contributions is disregarded, then the rules under IRC §401(a)(31)(B) apply to a mandatory distribution made before the participant reaches the later of age 62 or normal retirement age, even though the actual amount being distributed is more than $5,000. Note that the entire amount being distributed in this circumstance is subject to the automatic rollover rule.[135] Any references in this discussion to involuntary distributions of $5,000 or less are intended to encompass distributions that exceed $5,000, but are subject to the automatic rollover rule under IRC §401(a)(31)(B), because of this rule disregarding rollover contributions.

EXAMPLE 10-13. Automatic Rollover Requirements When Balance in Rollover Account Causes Account Value to Exceed $5,000. An employee, K, starts a new job on March 1, 2018. K's new employer's 401(k) plan has immediate eligibility and accepts rollover contributions. K receives an eligible rollover distribution from K's prior employer's plan in the amount of $25,000, which K rolls over to the new employer's 401(k) plan. K terminates employment

[134] IRC §411(a)(11)(D).
[135] Notice 2005-5, IRB 2005-3, Q&A-14.

on April 20, 2019. At that time, K's vested account balance is $29,800: $27,500 attributable to K's rollover contribution (with earnings), and the remaining $2,300 attributable to pre-tax elective contributions and matching contributions credited during K's period of participation in the current employer's 401(k) plan. The plan provides for an involuntary cash-out distribution, as soon as administratively feasible, following a participant's termination of employment if the value of the participant's vested account balance is $5,000 or less. If the plan contains authorizing language, it may treat this employee's vested account balance as not exceeding $5,000, and may distribute the entire vested account balance, $29,800, in an involuntary cash-out distribution. Such a distribution is covered by the automatic rollover rule under IRC §401(a)(31)(B), and the automatic rollover of the distribution is eligible for the DOL's fiduciary safe harbor (discussed below) if the conditions of the safe harbor are satisfied.

The disregarding of rollover contributions is not permitted, however, in determining whether the benefit exceeds $1,000 for purposes of the automatic rollover rules discussed above. Therefore, a participant whose account balance is less than $1,000 after excluding rollover contributions, but whose total account is between $1,000 and $5,000 when the rollover account is included, must still be provided with an automatic rollover rather than a cash distribution.[136]

The automatic rollover rule under IRC §401(a)(31)(B) does not apply unless there is no affirmative election made by the participant. The participant's election may be for cash or it may be for a direct rollover to a recipient plan or IRA of the participant's choice. Although the absence of the affirmative election results in an automatic rollover under these rules, the participant might still want to complete an election for a direct rollover so that he or she participates in the rollover process (e.g., choosing the IRA or other eligible recipient plan, or choosing the initial investments of the rollover IRA).

It is possible that, when the plan makes an involuntary cash-out distribution of $5,000 or less, all or a portion of the distribution might not be eligible for rollover.[137] For example, if an involuntary cash-out distribution of $3,500 is being made with respect to a participant who has attained age 70½, a portion of the distribution might represent a minimum distribution under IRC §401(a)(9), in which case only the amount above such portion would be subject to the automatic rollover rule under IRC §401(a)(31)(B).

Loan Defaults and Offsets

The automatic rollover rules do not apply to a deemed distribution under IRC §72(p), nor to the loan offset portion of a distribution.[138]

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[136] IRC §401(a)(31)(B).
[137] Notice 2005-5, IRB 2005-3, Q&A-1.
[138] Notice 2005-5, IRB 2005-3, Q&A-1.

IRS Guidance Applies IRC §401(a)(31)(B) to All Mandatory Distributions in Excess of $5,000

Because the automatic rollover rule is used only if the mandatory distribution is payable before the participant has attained the later of age 62 or normal retirement age, the rule under IRC §411(a)(11)(D) in relation to disregarding the rollover account to determine whether the participant's account is greater than $5,000 is generally the only circumstance under which distributions in excess of $5,000 will be subject to the automatic rollover rule. However, when a defined contribution plan terminates, it is also possible that amounts in excess of $5,000 will be distributed on an involuntary basis to participants who have not attained the later of age 62 or normal retirement age, and the amount in excess of $5,000 will not necessarily be attributable to rollover contributions. These involuntary distributions are subject to the automatic rollover rule in the absence of an affirmative participant election.[139]

If You're Curious . . .

Fiduciary Relief for Automatic Rollovers under IRC §401(a)(31)(B)

The DOL regulations provide a framework under which the plan sponsor or other fiduciary can comfortably implement the automatic rollover rule with the knowledge that his or her ERISA fiduciary responsibilities with respect to the participant are being satisfied.[140] The safe harbor covers the selection of the IRA as well as the initial investment of the rollover contribution. As a safe harbor, the standards prescribed by the final regulations are not intended to represent the exclusive means by which a fiduciary might fulfill his or her duties under ERISA with respect to automatic rollovers. As a practical matter, however, fiduciaries will probably implement automatic rollovers in a manner consistent with the safe harbor. If the fiduciary implements the automatic rollover through means that do not comply with the safe harbor, the fiduciary is not guaranteed that his or her choice of IRA provider or initial selection of investments in the IRA satisfies the ERISA fiduciary standards of prudence and diversification.

Ending the Plan Fiduciary's Responsibility

Normally, when a plan makes an automatic rollover to an IRA, the fiduciary remains responsible until the earlier of:

- The date the participant takes control over the IRA; or
- One year after the benefit is transferred to the IRA.[141]

For this purpose, the participant is deemed to take control over the IRA if he or she makes investment decisions with respect to the IRA or elects to transfer the funds to another IRA.

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[139] Notice 2005-5, IRB 2005-3, Q&A-2.
[140] DOL Reg. §2550.404a-2.
[141] ERISA §404(c)(3)(A).

If the DOL's fiduciary safe harbor is satisfied, the fiduciary's obligations with respect to the participant's benefit end immediately upon the transfer of the benefit to the IRA in accordance with the safe harbor rules.

Safe Harbor Conditions for Fiduciary Relief

The conditions of the safe harbor are intended to comply with the direction in EGTRRA §657(c)(2) (B) to provide special relief with respect to the use of low-cost IRAs. The safe harbor has the following five conditions:

1) An amount limitation;

2) The establishment of a proper IRA;

3) A written agreement between the IRA provider and the plan fiduciary which sets forth the requirements for the IRA safe harbor investment;

4) Disclosure to participants; and

5) No prohibited transaction involved with respect to the IRA being used to satisfy the automatic rollover requirement.[142]

Condition #1 of the fiduciary safe harbor: amount limitation. The fiduciary safe harbor does not apply unless the amount automatically rolled over does not exceed $5,000, unless the amount in excess of $5,000 is attributable solely to rollover contributions and the plan has adopted the rule described above that disregards rollover contributions in determining whether the plan's involuntary cash-out limit is exceeded.[143]

The final DOL regulations allow for the application of the fiduciary safe harbor to automatic rollovers of less than $1,000 as long as the other conditions of the safe harbor are satisfied. This way, if a plan sponsor wanted to deal with all involuntary cash-out distributions in the same fashion, it could do so without worrying about whether the fiduciary safe harbor would apply to the automatic rollover of an amount less than $1,000. However, it is not required that the plan extend the automatic rollover rule to cash-out distributions of less than $1,000.

On the other hand, if the plan provides for a default rollover involving amounts greater than $5,000, the fiduciary is not guaranteed protection even if the fiduciary follows the safe harbor guidelines in these regulations with respect to the establishment of the IRA receiving that default rollover. In addition, the fiduciary would remain liable with respect to the investment decisions relating to the rollover IRA until the participant assumes control over the IRA or, if earlier, one year after the rollover is completed.[144]

Condition #2 of fiduciary safe harbor: establish proper IRA. The IRA receiving the automatic rollover must be an individual retirement plan described in IRC §7701(a)(37), meaning that it is a traditional IRA and either:

• A trust or custodial individual retirement account under IRC §408(a); or

[142] ERISA §404(c)(3)(A).
[143] DOL Reg. §2550.404a-2(c)(1).
[144] ERISA §404(c)(3)(A).

• An individual retirement annuity under IRC §408(b).[145]

A traditional IRA means that it is not a Roth IRA. In addition, the automatic rollover may not be made to a SIMPLE IRA. This is because direct rollovers from qualified plans cannot be rolled over directly to SIMPLE IRAs. However, the IRA may be a deemed IRA that meets the requirements of IRC §408(q).[146]

When the participant's benefit is transferred to the traditional IRA in an automatic rollover transaction, taxation of the benefit is not triggered. Instead, the amount will become taxable when it is withdrawn from the IRA (or upon conversion of the IRA to a Roth IRA, pursuant to IRC §408A(d)).

If an automatic rollover under IRC §401(a)(31) includes designated Roth contributions, those amounts have to be rolled into a Roth IRA.

If the IRA is a trust or custodial account, the trustee or custodian must be a bank, an insured credit union, a corporation subject to supervision and examination by the Commissioner of Banking or other state officer in charge of the administration of banking under the laws of the state, or a qualified nonbank trustee within the meaning of IRC §408(n).[147]

The DOL decided against imposing any requirement regarding the financial stability of the provider of the IRA. In the preamble to the proposed regulations, the DOL had noted its belief that "existing Code and regulatory standards are sufficiently protective of separating participants and their beneficiaries who would become individual retirement plan account holders, without imposing unnecessary burdens on either plans or individual retirement plan providers." Thus, the plan fiduciary is not required to investigate the financial stability of the IRA provider.

Condition #3 of the fiduciary safe harbor: written agreement between fiduciary and IRA provider. In connection with the distribution of rolled-over funds to an IRA, the plan fiduciary must enter into a written agreement with an IRA provider that sets forth certain requirements.[148] The fiduciary may rely on commitments of the IRA provider as reflected in the agreement, and is not required to monitor the provider's compliance with the terms of the agreement beyond the point in time funds are rolled over in accordance with the terms of the agreement. Thus, the fiduciary's responsibility with respect to automatic rollovers under IRC §401(a)(31)(B) ends at such time as the funds are placed with the IRA provider pursuant to a written agreement that satisfies these requirements.

The rolled-over funds must be invested in an investment product designed to preserve principal and provide a reasonable rate of return. The rate of return need not be guaranteed. However, the investment must be consistent with liquidity. This limitation applies only so long as the participant on whose behalf the IRA is established has not assumed control over the investment decisions with respect to the IRA.

Examples of acceptable investment products are:

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[145] DOL Reg. §2550.404a-2(c)(2).
[146] Notice 2005-5, IRB 2005-3, Q&A-11.
[147] Treas. Reg. §1.408-2(e).
[148] DOL Reg. §2550.404a-2(c)(3).

• Money market funds maintained by a mutual fund company;

• Interest-bearing savings accounts and certificates of deposit of a bank or financial institution; and

• Any stable value products issued by a regulated financial institution that are fully benefit-responsive to the holder of the IRA.

The safe harbor does not apply if other investments are used, even if such investments represent the investment allocation previously directed by the participant or chosen by a fiduciary of the plan. If such other investments are chosen, it does not necessarily mean that there is a violation of ERISA.

It simply means that the fiduciary responsible for the decision is not eligible to rely on the DOL's fiduciary safe harbor with respect to the initial investment selection.

The investment product selected for the rolled-over funds must seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product by the IRA.

The investment product selected for the rolled-over funds must be offered by a regulated financial institution. A regulated financial institution for this purpose is:

• A bank or savings association, the deposits of which are insured by the FDIC;

• A credit union, the member accounts of which are insured within the meaning of §101(7) of the Federal Credit Union Act;

• An insurance company, the products of which are protected by state guaranty associations; or

• An investment company registered under the Investment Company Act of 1940 (i.e., a mutual fund company).

The financial institution that serves as the IRA provider would not necessarily have to be the financial institution that offers the investment product. For example, a bank might be the IRA provider, but the investment might be a money market fund offered by a mutual fund company.

All fees and expenses attendant to the IRA, including the investments of the IRA, must not exceed the fees and expenses charged by the IRA provider for comparable IRAs established for reasons other than the receipt of a rollover distribution subject to the provisions of IRC §401(a)(31)(B). Fees and expenses include, for example, establishment charges, maintenance fees, investment expenses, termination costs, and surrender charges.

The participant on whose behalf the IRA is established must have the right to enforce the terms of the contractual agreement against the IRA provider. This provision was added by the final regulations. It ensures that after the plan fiduciary is out of the picture (i.e., upon transfer of the funds to the IRA), the participant is able to enforce his or her rights with respect to the IRA (e.g., the comparability standard for fees and expenses).

Condition #4 of the fiduciary safe harbor: disclosure. The fiduciary safe harbor is not available unless participants have been furnished information about the plan's automatic rollover procedures in the SPD or in a summary of material modifications (SMM).[149] The information must include:

• An explanation that the mandatory distribution will be invested in an investment product designed to preserve principal and provide a reasonable rate of return and liquidity;

• A statement indicating how fees and expenses attendant to the IRA will be allocated (i.e., the extent to which such fees will be covered by the IRA alone or shared with the distributing plan or plan sponsor); and

• The name, address and phone number of a plan contact (to the extent not otherwise provided in the SPD or SMM) for further information concerning the plan's automatic rollover provisions, the IRA provider and the fees and expenses attendant to the IRA. This information can be identified by reference to a person, position or office, along with an address and phone number of the contact.

The requirement to provide information through the SPD or SMM is separate from any other disclosures that might be necessary as part of the distribution process. IRC §402(f) requires the plan administrator to provide the participant a tax notice describing the direct rollover rules and the withholding requirements if an eligible rollover distribution is not rolled over. In addition, IRC §401(a) (31)(B)(i) requires the plan to notify the participant that the automatic rollover has been made and that the participant has the right to transfer the funds to a different IRA.

Condition #5 of fiduciary safe harbor: no prohibited transactions (PTs). The selection of the IRA or any investment product within the IRA may not result in a PT.[150] For example, if the plan sponsor, in its capacity as the plan fiduciary, received personal compensation from a third party in connection with the establishment of the IRA, the plan sponsor would be in violation of the self-dealing rules under ERISA §406(b)(3) and IRC §4975(c)(1)(F), and the fiduciary safe harbor would not be available.

A PT generally will not result if the plan sponsor (or other independent fiduciary) directs a financial institution with whom the plan has a relationship to be the default provider of IRAs that will be used to comply with IRC §401(a)(31)(B). It is critical, however, that the financial institution not control the decision, particularly if it is serving in a fiduciary capacity with respect to the plan. Remember, a fiduciary cannot use his or her authority as a fiduciary to benefit personally, nor to increase the fiduciary's compensation from the plan or from a third party.[151]

There should not be a problem with the independent fiduciary providing a standing order to use the financial institution's IRA and investment products (or those of the financial institution's affiliates), so long as there are adequate safeguards.

If a fiduciary is providing investment advice to the plan, and recommends an investment in its own proprietary investment product with respect to the selection of the IRA, the mere presence of an unrelated second fiduciary (such as the employer) acting on the

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[149] DOL Reg. §2550.404a-2(c)(4).
[150] DOL Reg. §2550.404a-2(c)(5).
[151] IRC §4975(c)(1)(E) and (F) and ERISA §406(b).

investment advisor's recommendations on behalf of the plan, is not sufficient to insulate the advisor from fiduciary liability under ERISA §406(b).[152]

A class exemption was issued simultaneously with the issuance of the final regulations to allow plan sponsors that are also IRA providers (or whose affiliates are IRA providers) to use their own IRAs (or an affiliate's IRAs) and investment products, so long as the conditions of the class exemption, as well as the other conditions of the fiduciary safe harbor, are satisfied.[153] The exemption covers automatic rollovers under IRC §401(a)(31)(B), and applies to:

• The fiduciary who uses its authority to designate itself or an affiliate as the IRA provider that will receive the automatic rollover;

• The initial investment of the automatic rollover by the fiduciary in an investment product in which the fiduciary or its affiliate has an interest (i.e., a proprietary investment product);

• The receipt of fees by the IRA provider in connection with the establishment or maintenance of the IRA; and

The receipt of investment fees by the IRA provider or an affiliate as a result of the investment of the automatic rollover in a proprietary investment product.

Lowering Involuntary Cash-Out Threshold to $1,000 or Less to Avoid Automatic Rollover Requirements

Some plan sponsors have lowered the plan's involuntary cash-out threshold to $1,000 or less to avoid having to comply with the automatic rollover rule under IRC §401(a)(31)(B).

EXAMPLE 10-14. Plan Lowers Cash-out Threshold to $1,000 To Avoid Automatic Rollover Rules. A 401(k) plan provides that a participant's account is involuntarily cashed out as soon as administratively feasible following termination of employment if the value of the vested account balance is $1,000 or less.

Two participants terminate in April 2018. E's vested account balance is $850. M's vested account balance is $2,300. The plan involuntarily cashes out E's account. The plan makes the distribution in cash. M's account is not distributed under the plan's involuntary cash-out provision. M's account will be distributed only upon M's election to consent to distribution (subject to the minimum distribution requirements under IRC §401(a)(9)).

The distribution to E does not violate IRC §401(a)(31)(B) because the involuntary cash-out distribution does not exceed $1,000. The plan still must provide E (and other similarly situated participants) with an opportunity to elect a direct rollover,

[152] Preamble to the proposed exemption, footnote 15, which cites DOL Advisory Opinions 84-03A and 84-04A.
[153] PTE 2004-16.

> pursuant to IRC §401(a)(31), but can retain cash as the default method of payment for involuntary cash-outs under $1,000. The automatic rollover rule does not apply to M because the plan is not making an involuntary cash-out distribution of M's benefit.

Although a plan like the one in this example has successfully avoided the automatic rollover rule, it may have more small accounts remaining in the plan for longer periods of time. This might increase the plan's recordkeeping or other administrative costs.

Effect on QJSA Rules

If the plan is subject to the QJSA rules under IRC §417 and is amended to require participant consent to distributions above $1,000, the plan may still require lump sum payment for vested account balances not exceeding $5,000, without needing spousal consent.[154] This is because the exception to the spousal consent rule under Treas. Reg. §1.417(e)-1(b) (2)(I) refers to the cash-out limit under IRC §411(a)(11) without regard to the plan's consent rule with respect to the participant. In Example 10-14 above, if the plan were subject to the QJSA rules, it could still provide that a lump sum is the sole form of payment available to M, even though M's consent to the distribution is needed, M's spouse would not have consent rights under IRC §417.

Automatic Rollover Rule Does Not Apply to Former Spouses or Surviving Spouses

Although eligible rollover distributions are possible to surviving spouses[155] and to a spouse or former spouse who is an alternate payee under a qualified domestic relations order (QDRO),[156] such distributions are not mandatory distributions within the meaning of IRC §401(a)(31)(B).[157] If an involuntary distribution is made to either of these types of beneficiaries in an amount exceeding $1,000, the default method of payment may still be cash.

10.07: Special Rules for Plan Terminations

Because a plan that has been terminated must be liquidated within a reasonable period of time (generally, one year[158]), the regulations make some accommodations with respect to the consent requirements.

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[154] Notice 2005-5, IRB 2005-3, Q&A-13.
[155] IRC §402(c)(9).
[156] IRC §402(e)(1)(B).
[157] Notice 2005-5, IRB 2005-3.
[158] Rev. Rul. 89-87, IRB 1989-27, 5.

DEFINED CONTRIBUTION PLANS WITH NO ANNUITY OPTIONS

If the terminated plan is a defined contribution plan that does not offer an annuity option, distributions upon plan termination may be made without a participant's consent, regardless of whether the participant's vested interest exceeds the cash-out limit or whether the participant has reached normal retirement age.[159] The plan may also mandate that the involuntary distributions be made in a lump-sum payment (whether as cash or as a direct rollover).

This exception does not apply if the employer that maintains the terminated plan, or any entity with the same controlled group as the employer, maintains another defined contribution plan (other than an ESOP). In that case, there would have to be at least an option for the participant to have the benefits transferred from the terminated plan to the other defined contribution plan.

If the defined contribution plan is a pension plan (money purchase pension plan or target benefit plan), it cannot qualify for this exception. This is because the plan is required to offer an annuity option by virtue of the QJSA rules under IRC §§401(a)(11) and 417.

This exception does not affect the requirement to provide the rollover notice by IRC §402(f). In addition, if the participant has not reached the later of age 62 or normal retirement age, the automatic rollover rule under IRC §401(a) (31)(B) applies if the distribution is more than $1,000.[160] If the amount exceeds $5,000, but the excess is not attributable solely to rollover contributions (within the meaning of IRC §411(a)(11)(D)), the DOL's fiduciary safe harbor under DOL Reg. §2550.404a-2 is not available with respect to the selection of the IRA investments regarding the automatic rollover.

PROCEDURE IF TERMINATED DC PLAN HAS ANNUITY OPTIONS OR EMPLOYER MAINTAINS ANOTHER DC PLAN

The exception described above does not apply to a terminated defined contribution plan that includes annuity options, or to plans without annuity options that are maintained by employers who have other defined contribution plans. If the exception does not apply, then the normal notice and consent rules apply to distributions from the terminated plan.

Vested Interests Exceeding Cash-Out Limit

If a participant's vested interest exceeds the involuntary cash-out limit, and the participant will not consent to an immediate distribution, the plan must pay a deferred annuity contract that will commence benefits at normal retirement age (or age 62, if later). The deferred annuity contract must protect optional forms of benefit that would have been available to the participant had the plan not terminated and that are not permitted to be eliminated.[161] If the plan is subject to the

[159] Treas. Reg. §1.411(a)-11(e).
[160] Notice 2005-5, IRB 2005-3, Q&A-2.
[161] Treas. Reg. §1.411(d)-4, Q&A-2(a)(3)(ii).

QJSA requirements, the deferred annuity contract must provide for payment in the QJSA form, unless a valid waiver is made by the participant within 30 to 180 days before the date payments would commence under the annuity.

Transfer to Another Defined Contribution Plan

As an alternative to issuing a deferred annuity contract, the benefit could be transferred to another defined contribution plan maintained by the employer, provided the other plan protects the optional forms of benefit available with respect to the transferred benefit. This transfer option is not required if the other defined contribution plan is an ESOP.

Participants Who Have Attained Normal Retirement Age or Age 62 (if Later)

If the participant has reached the later of normal retirement age or age 62, a deferred annuity contract would not have to be obtained in the absence of consent to an immediate distribution. Instead, the plan could force the participant to take an immediate distribution in a default form of payment (usually a QJSA, if the plan has annuity options), but the participant must have an opportunity, in accordance with the consent rules under IRC §§411(a)(11) and 417, to choose an optional form of benefit (unless the plan offers only one payment method) or to elect a direct rollover.

Vested Interests Not Exceeding Cash-Out Limit

If a participant's vested interest does not exceed the involuntary cash-out limit, then the plan may proceed with the distribution in accordance with the cash-out rules. This includes compliance with the automatic rollover rule under IRC §401(a)(31)(B) as the default method of payment in the absence of an affirmative participant election.

MISSING PARTICIPANTS AND BENEFICIARIES UNDER TERMINATED PLANS

Recognizing that Rev. Rul. 89-87 requires a terminated plan to distribute all assets as soon as administratively feasible, the DOL has issued informal guidance—Field Assistance Bulletin 2014-01 (FAB 2014-01, dated August 14, 2014)—with respect to missing participants under terminated defined contribution plans. For this purpose, a missing participant is considered to be a participant who cannot be found or is unresponsive to the plan's request for communication. If the distribution involves a deceased participant, and the beneficiary cannot be found or is unresponsive, the same principles would apply with respect to the distribution of benefits for the missing beneficiary.

The DOL focuses on the fiduciary's obligations regarding missing participants. The decision to terminate a plan is a settlor function, but the steps to implement the decision to terminate, including steps to locate missing participants, are governed by ERISA's fiduciary standards. The choice of a distribution option with respect to a missing participant's account is a fiduciary decision. Therefore, the fiduciary has a duty to take reasonable steps to locate the participant, keeping in mind that fees and expenses incurred in the administration of the plan must be reasonable and necessary, and the manner in which distribution is completed must be prudent and not contrary to the governing plan documents (except to the extent such documents would violate ERISA).

If You're Curious . . .

Acceptable Search Methods to Establish that a Participant (Or Beneficiary) is Missing

FAB 2014-01 describes specific methods that can be used to locate a missing participant. In choosing the appropriate method(s), the fiduciary may consider the size of the participant's account and the expenses involved in attempting to locate the individual. Expenses attendant to efforts to locate the individual may be charged against that participant's account, as long as the amount of the expenses so charged is reasonable and consistent with the terms of the plan and the fiduciary's duties.

FAB 2014-01 lists certain search methods that involve such nominal expense and such potential for effectiveness that every plan must employ these methods, regardless of the size of the account, or the plan fiduciaries have not satisfied their fiduciary obligations. In the DOL's view, a plan cannot proceed unless it has tried these methods:

• Send notice by certified mail to the last known address.

• Determine whether the employer's records or the records of another plan maintained by the employer (e.g., a group health plan) have a more current address. If there are privacy concerns, the fiduciary should ask the employer or the other plan's fiduciary to forward a letter.

• Attempt to contact anyone who has been named as a beneficiary of the participant (e.g., a spouse or child). If there are privacy concerns, the fiduciary should ask the beneficiary to forward a letter.

• Use free electronic search tools to locate the participant. Online services may include Internet search engines, public record databases (such as those for licenses, mortgages and real estate taxes), obituaries and social media.

FAB 2014-01 also lists other options that the fiduciary might consider, but does not require that these methods be used in all cases. These methods include the use of Internet search tools, commercial locator services, credit reporting agencies, information brokers, investigation databases and analogous services that may involve charges. The fiduciary needs to consider whether, under the facts and circumstances, it would be prudent to use these other methods. If the expenses attendant to the search will be charged to the participant's account, the fiduciary needs to consider the size of the participant's account relative to the fees that would be incurred in deciding whether to use any of these alternatives.

Distribution Options with Respect to a Missing Participant's (or Beneficiary's) Interest

If the prudent search does not result in locating the individual, the plan needs to proceed with the distribution of the account. Here again, FAB 2014-01 recommends options.

IRA Rollover is Primary Distribution Method

The primary means of distributing the benefit should be a rollover to an IRA. With the release of the DOL's fiduciary safe harbor for automatic rollovers made pursuant to IRC §401(a)(31)(B),[162] it should be relatively easy to find IRA providers that will establish IRAs for missing participants. The DOL favors this approach because it is the one most likely to preserve assets for retirement. Also, because immediate income tax is not triggered, there is no income tax withholding taken, and for missing participants who are under age 59½, the 10 percent tax on early distributions under IRC §72(t) likewise does not apply.

The DOL also notes that if the investment product chosen for the IRA is one designed to preserve principal (i.e., investments that would also be suitable under the fiduciary safe harbor under DOL Reg. §2550.404a-2), the DOL would view the distribution of the benefit to the IRA as satisfying the fiduciary's duty in connection with the distribution, and thus not subject to enforcement. This is true even if the amount involved exceeds the involuntary cash-out limit and, therefore, is normally not eligible for the fiduciary safe harbor.

This nonenforcement relief applies only in the case of a missing participant. If the participant is not missing but fails to make an affirmative election, an automatic rollover might nonetheless be triggered. The DOL has not addressed the fiduciary issues where such distributions are in excess of $5,000.

Alternative Distribution Methods

The DOL acknowledges that the fiduciary may not be able to complete the distribution through the rollover process because it will be unable to find an IRA provider that will accept the rollover, especially in the case of a very small account balance. In that case, the DOL offers two alternatives: transfer to a bank account, or transfer to state unclaimed property funds.

The PBGC Missing Participant Program will accept funds and participant information for a processing fee, but only for terminating defined contribution plans.

Transfer to Bank Account. The bank account should be a federally-insured interest-bearing account. Transfer to the bank account will trigger immediate income taxation (i.e., Form 1099-R must be filed), as well as withholding requirements, and may trigger an additional 10 percent tax on early distributions if the participant is under age 59½, and is not otherwise exempt from the penalty. In fulfilling its fiduciary obligation, the fiduciary should consider the interest rate for the account, the length of time such interest rate is guaranteed, and any applicable bank fees.

Transfer to State Unclaimed Property Funds. This option involves a transfer of the account to state unclaimed property funds in the state of the missing participant's last known address or work location. The DOL clarifies that its position in Advisory Opinion 94-41A—where it stated that ERISA preempts a state's unclaimed property statute—is not applicable here. Advisory Opinion 94-41A was addressing the situation where the

[162] DOL Reg. §2550.404a-2.

state unclaimed property law was being used to require ongoing plans to turn over the account balances of missing participants. The DOL does not believe that ERISA would prevent a fiduciary from voluntarily deciding to transfer missing participants' accounts to the state under an unclaimed property law, in order to complete the termination of a plan. The DOL also notes that a transfer of funds to the state would also be treated as a plan distribution, ending the missing individual's status as a participant (or beneficiary) and the treatment of the transferred assets as plan assets.

In deciding between the transfer to a bank account and the transfer to the state's unclaimed property fund, the fiduciary should evaluate the interest accrual and bank fees associated with the bank account against the availability of the state unclaimed property fund's searchable database. The database might facilitate the potential for recovery of the funds by the missing participant.

100 Percent Withholding Would Violate ERISA. The DOL is aware that some fiduciaries have taken the step of withholding 100 percent of the missing participant's distribution as income tax withholding and, in effect, turning over the account to the IRS. After discussing this issue with the IRS, the DOL has concluded that this approach would violate ERISA's fiduciary standards.

Plans with Annuity Options; Employers Who Maintain Other Defined Contribution Plans. In footnote 5 of FAB 2014-01, the DOL notes that the guidance in the bulletin does not apply in the case of plans that provide annuity options or where the employer (or related group) maintains another appropriate defined contribution plan that is not terminating. This is consistent with the Treasury's guidance regarding involuntary distributions under terminated plans.[163] If there are annuity options, then the qualified joint and survivor annuity (QJSA) rules apply. In that case, unless the benefit does not exceed the involuntary cash-out limit under IRC §411(a)(11) (i.e., $5,000, plus rollover contributions if IRC §411(a)(11)(D) applies), the distribution for a missing participant must be in the form of a deferred QJSA, commencing at normal retirement age (or an irrevocable commitment by the insurance company, in exchange for the account balance, to issue an annuity if the missing participant claims the benefit). The deferred annuity must protect the optional forms of benefit that were available to the participant under the plan, except to the extent an exception under IRC §411(d)(6) applies. If the missing participant has already attained normal retirement age, the QJSA may be an immediate annuity (or the irrevocable commitment purchased from an insurance company to issue an immediate annuity upon the participant's providing proper identification to the insurance company).

If the employer maintains another defined contribution plan (other than an ESOP), the missing participant's account should be transferred to that other plan, unless the deferred annuity option (or irrevocable insurance commitment) is used. The transferee plan will have to protect the optional

forms of benefit that were available to the participant under the terminated transferor plan, except to the extent an exception under IRC §411(d)(6) applies.

Annuity Options Could Be Eliminated by Plan Amendment In The Case Of A Nonpension Plan. In the case of a defined contribution plan that is not a pension plan (i.e., the plan is not a money purchase pension plan or target benefit plan), the plan can be

[163] Treas. Reg. §1.411(a)-11(e).

amended to eliminate annuity options.[164] Such an amendment could be adopted in conjunction with the termination of the plan. Unless there is another defined contribution plan that could receive transfers of the missing participant's account, the elimination of the annuity options will allow the terminated plan to proceed under the options discussed in the field assistance bulletin.

If the nonpension plan includes a transferred account balance from a money purchase pension plan or target benefit plan under which the QJSA requirements must be protected (e.g., transfer by plan merger), the amendment will not be able to eliminate the annuity options (at least not the QJSA option) from the transferred pension assets, unless the value of those assets is $5,000 or less.[165] This requirement to protect the QJSA applies when the transfer occurs by employer action (e.g., plan merger) or in the case of an elective transfer due to certain business transactions or employment status changes.[166]

10.08: Life Insurance Benefits

This section addresses the tax consequences to the participant when life insurance is purchased for his or her benefit inside a plan. If the participant dies with life insurance in force, the proceeds under that contract are payable to the participant's beneficiary or to the plan, depending on how the policy is set up.

TERM COST OR P.S. 58/TABLE 2001 COST OF INSURANCE

Life insurance, in its purest form, is a one-year agreement between the owner of the policy and the insurance company. The owner agrees to pay the insurance company a fee, called a premium. The insurance company, in turn, agrees to pay the policy beneficiary if the insured person dies during the year. Because it is generally unlikely that a given individual will die during the year, the insurance company will pay many times the premium to the beneficiary if death occurs. (This is somewhat like giving odds in a gambling game based on the likelihood of an event occurring.) The amount that the insurance company will pay is called the **face amount**.

In reality, actual insurance policies are often more complex. In addition to the cost of the one-year agreement (called the **term cost**), part of the premium paid by the owner goes to expenses incurred by the insurance company in providing the policy, commissions to the insurance salesperson, and a profit for the company. Furthermore, the owners of many policies actually pay more each year than the term cost and expenses, and the excess amount is invested by the insurance company. In later years, the invested portion and the earnings thereon (called the **reserve accumulation**) may be used to pay part of the premium (term costs increase each year as the insured ages, because the likelihood of death during subsequent years increases), or the policy may be surrendered and the owner can remove all or a portion of that reserve. The portion of the reserve accumulation of the policy that would be paid to the owner if the policy is

[164] Treas. Reg. §1.411(d)-4, Q&A-2(e).
[165] Rev. Rul. 94-76, IRB 1994-50,and Rev. Rul. 2004-12, IRB 2004-7.
[166] Treas. Reg. §1.411(d)-4, Q&A-3(b).

surrendered is generally called the cash value or **cash surrender value**. If the insured dies, the reserve customarily is used to pay part of the face amount.

Because the term portion of the premium provides insurance for the current year, when the insurance is owned by a retirement plan, the IRS deems it to be a current benefit. Therefore, unlike the balance of the retirement plan, the participant is required to pay taxes on the benefit that he or she receives during the year. The taxable amount is equal to the term cost of the insurance.

The IRS has published a table, called the P.S. 58 table, which estimates the term cost of insurance at each age of the insured. This table was updated in 2001, and is referred to by practitioners as Table 2001. Each year, the plan must issue a Form 1099-R to an insured participant, reflecting that participant's current benefit. For this purpose, the plan may use either the Table 2001 or the actual premium that would need to be paid by the plan to the insurance company to purchase an insurance policy that just covers the one year of insurance for the participant.

EXCLUSION FOR NET PROCEEDS

The net insurance proceeds paid to the beneficiary of a life insurance policy are excluded from the beneficiary's gross income.[167] The phrase net insurance proceeds means the amount by which the face amount of the policy exceeds the reserve accumulation (which is usually the cash surrender value) of the policy immediately before the participant's death.[168] The portion of the proceeds equal to the reserve accumulation is subject to the normal tax rules for plan distributions.

EXAMPLE 10-15. Life Insurance in Profit-Sharing Plan. D's profit-sharing plan account includes a life insurance policy. D dies on August 1. At D's death, the cash surrender value of the policy is $60,000. The policy pays proceeds of $300,000. The net insurance proceeds are $240,000, determined by subtracting $60,000 from $300,000.

Proration of Exclusion for Extended Payment Periods

If the beneficiary receives payments over more than one year, the exclusion for the net insurance proceeds must be prorated over the payment period.[169]

Recovery of Term Costs

Because an insured participant pays taxes each year on the term cost of the insurance in the plan, when the participant takes a distribution of the policy or when the participant dies and the

[167] IRC §101(a).
[168] Treas. Reg. §1.72-16(c)(2)(ii).
[169] IRC §101(d). Treas. Reg. §1.72-16(c)(3), Example (2).

beneficiary receives the face amount of the policy, the accumulated term costs that have been claimed as income constitute a basis in the policy. Therefore, the value of the policy equal to those accumulated costs is distributed to the participant or beneficiary tax-free.

EXAMPLE 10-16. Basis if Policy Distributed to Participant. Suppose in the prior example that D's beneficiary is D's spouse, K. After D passes away, K elects to receive a lump sum payment of the death benefit. The payment totals $375,000—$300,000 of which represents proceeds from the insurance policy, and $75,000 of which represents other accumulations in D's profit-sharing account balance. D did not make any after-tax employee contributions to the plan. The only amounts previously taxed to D were term costs under the insurance policy in the amount of $10,000. D's spouse computes the taxable amount as follows:

- Total distribution: $375,000
- The exclusion for net insurance proceeds ($300,000 - $60,000 cash surrender value): $240,000
- Term costs: $10,000
- Total exclusions from income ($240,000 + $10,000): $250,000
- Amount includible in income (total distribution received less excludable amounts, or $375,000 - $250,000): $125,000

Insurance on Self-Employed Individual in a Plan

Contributions made on behalf of a self-employed individual for the purchase of life, accident, health or other insurance are not deductible.[170] For example, term costs for the purchase of life insurance are not deductible by the self-employed individual. This places the individual on par with the common law employee, who must include in income the term costs deducted by the employer. By denying the self-employed individual the deduction, he or she is effectively including the term costs in income like a common law employee.

INCIDENTAL DEATH BENEFITS IN A PLAN

A plan may purchase life insurance as a means of providing death benefits under the plan. In a defined contribution plan, the purchase of insurance to provide benefits is a charge against the account and held as an earmarked investment for the participant's benefit.

[170] IRC §404(e).

Incidental Benefit Limit: The Percent-of-Contributions Rule

Life insurance purchased for a participant generally must be an **incidental life insurance benefit**, which is incidental to the plan's primary purpose of providing retirement benefits.[171]

Life insurance in a defined contribution plan is incidental if the cumulative premium cost for the life insurance does not exceed a certain percentage of the aggregate contributions allocated to the participant. This is known as the **percent-of-contributions** rule. In general, the insurance is incidental if the cumulative premium cost for term insurance does not exceed 25 percent of the aggregate contributions.[172] In applying the 25 percent limit, the entire premium cost of term insurance plus one-half of the premium cost of whole life insurance is taken into account.

The IRS treats universal life insurance as term insurance for purposes of the 25 percent limit. If the insurance is all whole life, the insurance is incidental if the total premium cost for the whole life policy is less than 50 percent of the aggregate contributions.

For purposes of the percent-of-contributions rule, the aggregate account contributions include employer contributions and forfeitures that are allocated to the participant's account, but not earnings on those amounts. Elective deferrals under a 401(k) plan are employer contributions for purposes of these limitations.

Note that after-tax employee contributions may also be used to purchase life insurance without regard to the incidental benefit limit (see below). Profit-sharing contributions may likewise be used to purchase life insurance without regard to these limits in certain circumstances (described below).

Pension Plans: the 100-Times Rule

Instead of using the percent-of-contributions rule, a pension plan may show life insurance benefits are incidental on a benefits basis. Under the **100-times rule**, life insurance benefits are incidental if the insurance benefit is no more than 100 times the anticipated monthly annuity benefit.[173] If the pension plan is a money purchase or target benefit plan, the anticipated monthly annuity benefit is determined by projecting the accumulated account balance at normal retirement age based on the plan's contribution formula. The 100-times rule is more often used by defined benefit plans because the benefit is already stated in the form of an annuity at normal retirement age.

Effect of QDRO

The IRS has not addressed how the incidental limits described above should be applied when a portion of a participant's benefit is awarded to an alternate payee (e.g., the participant's former

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[171] Treas. Reg. §1.401-1(b)(1)(I) and (ii).
[172] Rev. Rul. 54-51, 1954-1 C.B. 147, as amplified by Rev. Rul. 57-213, 1957-1 C.B. 157, and Rev. Rul. 60-84, 1960-1 C.B. 159; Rev.
Rul. 61-164, 1961-2 C.B. 99.
[173] Rev. Rul. 60-83, 1960-1 C.B. 157.

spouse) pursuant to a QDRO. For plans using the percent-of-contributions rule, the incidental limit is based on the aggregate contributions made by the employer, so the payment of QDRO benefits would not affect the calculation of the limit. For plans using the 100-times rule, the inclusion or exclusion of a QDRO award would likely affect the computation significantly.

In IRS Notice 87-21,[174] the IRS took the position that a participant's benefit paid to an alternate payee is included in determining whether the IRC §415 limits are exceeded with respect to the participant. Applying that principle here, it would seem reasonable to treat the awarded benefit as part of the participant's benefit for the incidental life insurance limits and, therefore, to include the QDRO benefits as part of the participant's benefit to compute the applicable limit.

Life Insurance May Not Continue Beyond Retirement

For life insurance to be incidental, the policy must be converted to retirement income or distributed to the participant no later than the normal retirement date under the plan.[175] The life insurance policy may be continued beyond retirement age, however, if the participant does not elect to retire.[176] The IRS Listing of Required Modifications published for prototype plans provides that conversion or distribution of the policy is not required until the annuity starting date (i.e., the date distributions commence). Although not addressed by the IRS, it should be reasonable to allow insurance coverage to continue beyond the required beginning date under IRC §401(a)(9), if the participant has not terminated employment.

Compliance with the incidental life insurance limits is a qualification issue, because the limits are imposed pursuant to the IRC §401 regulations. Corrective steps should be taken to reduce the face amount of the insurance if the incidental limit is exceeded. The IRS's correction programs under EPCRS should be available to correct the qualification failure.

Exception to Incidental Benefit Limit for Certain Profit-Sharing Plans

If a profit-sharing plan (or stock bonus plan) purchases life insurance only with seasoned contributions, the incidental life insurance limit does not apply. Contributions are seasoned if they have been accumulated in the trust for at least two years. This rule is based on the principle that, after profit-sharing contributions have accumulated for two years, it is permissible for the plan to permit distribution of those amounts.[177]

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[174] 1987-1 C.B. 458, Q&A-20.
[175] Rev. Rul. 54-51, 1954-1 C.B. 147.
[176] Rev. Rul. 57-213, 1957-1 C.B. 157.
[177] Rev. Rul. 71-295, 1971-2 C.B. 184, and Rev. Rul.60-83, 1960-1 C.B. 157.

Exception to Incidental Benefit Limit for Certain Employee Contributions

A plan may provide for the purchase of life insurance with after-tax employee contributions. The incidental life insurance limitations do not apply to insurance protection purchased with after-tax employee contributions.[178] Elective deferrals under 401(k) arrangements are treated as employer contributions, so the incidental limits discussed above do apply to those contributions.

Although not addressed specifically by the IRS, rollover contributions could arguably be used to purchase life insurance without regard to the incidental limits, because they are amounts that were distributable from the prior plan and have similar status for distribution purposes as after-tax employee contributions.

10.09: Review of Key Concepts

- Identify the information that must be provided to a participant in the required notice for a distribution to occur.
- What must the QPSA explanation contain when offering a waiver of the QPSA benefit?
- Explain the notice requirements of a distribution that is not an involuntary (cash-out) distribution.
- What is a rollover notice?
- Describe when participant consent applies to a plan distribution.
- Describe when spousal consent applies to a plan distribution.
- Explain the timing applicable to a participant's distribution election and consent.
- Describe the notice requirements necessary to accomplish an automatic rollover for account balances of less than $5,000 (i.e., less than the cash-out limit).
- What is the impact of the Windsor and Obergefell cases on qualified plans?
- Describe the circumstances in which a participant's spouse, who is the same sex as the participant, will be treated as spouse for qualified plan purposes.
- What is the incidental benefit limit for life insurance in a defined contribution plan?
- Describe the percent-of-contributions rule and the 100-times rule.

10.10: For Practice – True or False

1. The distribution notice describes the benefit payment options, right to delay distribution until at least normal retirement age, and direct rollover feature.
2. Certain distribution notice requirements depend on whether the QJSA rule applies to the participant.
3. The Supreme Court's invalidation of DOMA §3 (in Windsor) allows same-sex couples who are legally married to have many of the rights as opposite-sex couples, such as allowing for hardship distributions for spousal medical expenses.

[178] Rev. Rul. 69-408, 1969-2 C.B. 58.

4. A plan that requires spousal consent for a loan will need to obtain spousal consent from same-sex spouses as well as opposite-sex spouses.
5. Distribution notice requirements refer to information that must be provided to the participant before distributions may be made.
6. The $5,000 threshold for the notice and consent requirements is based on the participant's vested account balance as of the date of distribution.
7. When a participant takes a partial distribution, the consent given applies to the full account balance.
8. The beneficiary of a life insurance policy will be taxed on the total distribution from the policy.
9. A self-employed individual's contributions for the purchase of life insurance are not deductible by the self-employed individual.
10. Nonpension plans may use the 100-times rule for determining incidental benefit limits regarding life insurance.

10.11: Sample Test Questions

1. All of the following information must be provided to a participant prior to receiving a distribution due to termination of employment, EXCEPT:
   A. Loan procedures
   B. Taxation issues
   C. Information about how a distribution will be taxed
   D. The optional forms of payment available
   E. The right to delay payment until normal retirement age
2. Which notice must be provided to the participant?

- The plan is a target benefit plan.
- The participant is age 35 and terminates employment.
- The participant has a vested account balance of $750.
- The plan will make involuntary cash out of benefits.

   A. Waiver of the QJSA notice
   B. Optional forms of benefit notice
   C. Right to delay distribution to NRA notice
   D. Rollover notice
   E. Spouse's consent rights regarding a waiver of the QJSA

3. All of the following are affected by the Court's invalidation of DOMA §3, EXCEPT:

   A. Definition of spouse
   B. Rules for family attribution
   C. Application of QPSA and QJSA
   D. Rollover to spousal IRA
   E. Allocation of participant's contribution

4. Which of the following statements regarding life insurance in defined contribution plans is/are TRUE?

    I. The participant is required to pay taxes on the term cost of the insurance each year.
    II. Net insurance proceeds paid to the beneficiary are not taxable.
    III. Incidental life insurance can remain in the plan post-retirement until the participant elects a distribution.

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

5. Which of the following statements regarding the incidental life insurance benefit limit is/are TRUE?

    I. The limit for a term life insurance policy is 25% of the aggregate contributions.
    II. The limit for a whole life insurance policy is less than 50% of the aggregate contributions.
    III. The limit for a universal life insurance policy is less than 50% of the aggregate contributions.

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

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

10.12: Solutions to True or False Questions

1. True.
2. True.
3. True.
4. True.
5. True.
6. True.
7. False. The consent given for a partial distribution only applies to the partial distribution, not the full account balance.
8. False. The beneficiary is taxed on the net insurance proceeds, which is the face amount of the policy less the reserve accumulation.
9. True.
10. False. The 100-times rule is only applicable to pension plans.

10.13: Solutions to Sample Test Questions

1. The answer is **A**. The loan policy is not a notice that must be given at the time of distribution.
2. The answer is **D**. A participant with an account balance of less than $5,000 is only required to receive the rollover notice when an involuntary distribution is made.
3. The answer to this question is **E**. Employer and employee contribution allocations are not affected by DOMA.
4. The answer is **C.** A life insurance policy must be converted to retirement income or distributed to the participant no later than the normal retirement date under the plan in order to satisfy the incidental life insurance requirements.
5. The answer is **C**. A universal life insurance policy is treated as if it is a term insurance policy for purposes of the incidental benefit limit.

CHAPTER 11:

CODE OF PROFESSIONAL CONDUCT

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11.01: 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 (ARA) 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.

11.02: For Practice – True or False

1. Advertising includes all forms of communication whether oral, written or electronic.
2. Professional services include providing advice, recommendations, or opinions related to a retirement plan.
3. An ARA Member may disclose to another ARA Member confidential information learned about a client whenever asked by another ARA Member.
4. The ARA Code of Professional Conduct shall override IRS Circular 230.
5. An ARA Member who has the education, training and experience to advise a client regarding the benefits of a cash balance plan versus a target benefit plan may do so.
6. An ARA Member who is found guilty of a felony shall be subject to ARA's disciplinary procedures.
7. An ARA Member may provide professional services to a client who requests it even though the client is being served by another professional in the same manner.
8. If a request for information is received by an ARA Member from a person authorized by ARA to obtain information regarding a possible violation of the ARA Code of Professional Conduct, the Member shall respond promptly in writing.
9. A credential is a membership designation conferred by ARA.
10. Confidential information may include information which the ARA Member has reason to believe that the client would not wish to be divulged.

11.03: Sample Test Questions

1. All of the following statements are violations of ARA's Code of Professional Conduct, EXCEPT:
   A. Advertising that the Member is a CPC when the member has not received the designation from ARA.
   B. Advertising that the Member's firm employs only QKAs to do administration on 401(k) plans when the firm has other individuals administering the plans without the designation.

C. Orally informing a potential client that the Member's firm administers 1,500 401(k) plans when in reality it administers only 300.
D. On the Member firm's website advertising that the firm is qualified to administer ESOP plans when the firm has never administered one.
E. Providing a potential client written material that indicates any potential income it may receive from investment products that are purchased by the plan.

2. All of the following statements are violations of ARA's Code of Professional Conduct, EXCEPT:

A. After attending a client's confidential board meeting, you inform a friend that the client will merge with another firm so the friend can sell the company stock.
B. Your client requests that you provide another service provider participant account balance details and you do so electronically based on the new service provider's specifications.
C. You discuss your client's salary information with a friend interested in working for the client.
D. The President of the company you administer a profit-sharing plan for, notified you that the he would be informing the board next week that he is retiring and you repeat the information today to a shareholder.
E. The client has not paid your invoices so you tell the new administration firm that the client has a poor credit rating.

3. Which of the following statements regarding conflict of interest requirements under ARA's Code of Professional Conduct is/are TRUE?

I. The Member shall fully disclose any actual conflict of interest to a client.
II. The Member's ability to act fairly must be unimpaired.
III. The Client must expressly agree to the services that are provided by the Member.

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 ARA's Code of Professional Conduct are TRUE, EXCEPT:

A. An ARA Member shall render opinions or advice only when qualified to do so based on education, training and experience.
B. An ARA Member must adhere to the high standards of conduct, practice and qualification.
C. An ARA Member must abide by the ARA Code of Professional Conduct regardless of other laws.
D. An ARA Member shall take reasonable steps to ensure that services rendered under the Member's supervision are performed with honesty, integrity, skill and care.

E. An ARA Member shall perform services with courtesy and shall cooperate with others in the client's interest.

5. Which of the following statements is/are violations of ARA's Code of Professional Conduct?

- Your client has informed you that they are having cash flow issues and are not going to deposit employee 401(k) contributions into their 401(k) plan for six months so that they can use the funds to help meet their payroll obligations.
- There are 50 participants in their 401(k) plan.

I. You advise the client that this will result in a loan from the plan to the plan sponsor and is a prohibited transaction.

II. You advise the client that the employee contributions must be deposited to the plan within seven business days from when they would have been paid to the participants.

III. You listen to the client's concern with empathy, discuss how difficult it is for a small business to comply with the additional expenses generated by the new health care laws and concur with their course of action to solve their cash flow issues.

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

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

11.04: Solutions to True or False Questions

1. True.
2. True.
3. False. An ARA Member may only disclose confidential information about a client if the client has authorized the Member to do so.
4. False. The ARA Code of Professional Conduct is not intended to supplant, contradict or supersede Law (e.g., IRS Circular 230). 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.
5. True.
6. True.
7. True.
8. True.
9. True.
10. True

11.05: Solutions to Sample Test Questions

1. The answer is **E**. Providing information regarding income a firm receives from investments or from relationships it may have with other service providers is not a violation of the ARA Code of Professional Conduct.
2. The answer is **B**. It is not a violation of the ARA Code of Professional Conduct to provide information that a client has requested that you provide.
3. The answer is **E**. All statements are True.
4. The answer is **C**. Laws may impose binding obligations on a Member. The ARA Code of Professional Conduct is not intended to contradict or supersede the law.
5. The answer is **B**. Statement I and II are True. Statement III is false since the course of action the client has discussed would be violation of the law an ARA Member would want to avoid approving the action of the client.