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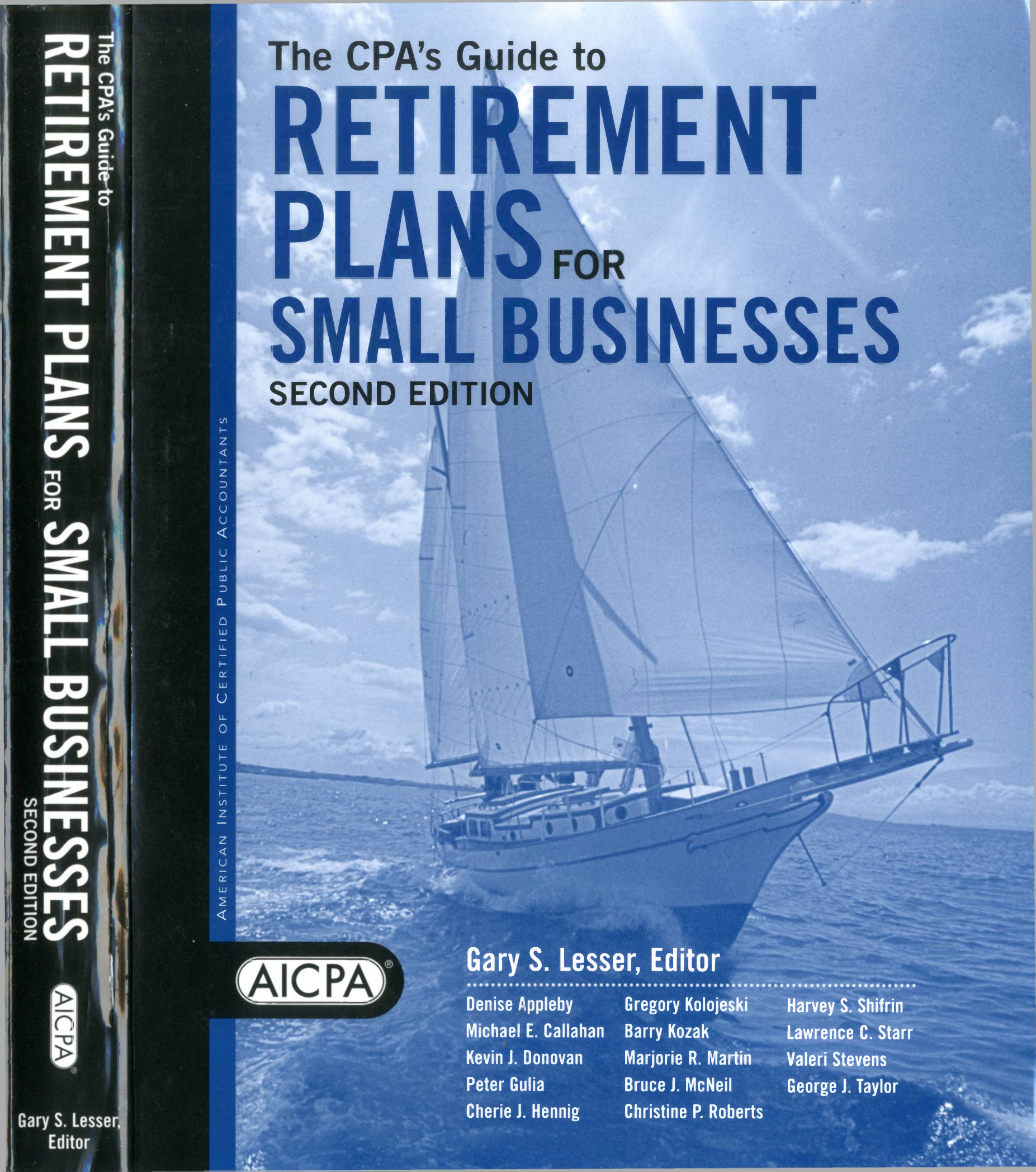
CPA's guide to retirement plans for small businesses

Gary S. Lesser

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The CPA's Guide to
**RETIREMENT
PLANS** FOR
SMALL BUSINESSES
SECOND EDITION

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS



Gary S. Lesser, Editor

Denise Appleby

Gregory Kolojeski

Harvey S. Shifrin

Michael E. Callahan

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Gary S. Lesser
2007

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No. 142, *Goodwill and Other Intangible Assets*, and FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. She co-authored with John Everett and William Raabe the text, *Practical Guide to Schedule M-3 Compliance*, published by CCH, a Wolters Kluwer business.

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George also chaired a committee that drafted ASPPA's Pension Reform Proposals. Part of this proposal is the Secure Assets For Employees (SAFE) Defined Benefit Plan. The SAFE Proposal has been introduced in the House and Senate. Many of the changes proposed in this Pension Reform Proposal were included in the Economic Growth and tax Reconciliation Act of 2001 (EGTRA) and the Pension Protection Act of 2006 (PPA). On June 12, 1997, he presented the SAFE Proposal, along with Rep. Earl Pomeroy (Dem. N.D.) to the ERISA Advisory Council on Employee Welfare and Pension Benefit Plans.

In addition to providing information on qualified and tax sanctioned plans in general, this book focuses on aspects of plan design for the smaller business owner. In addition, numerous chapters are devoted to other issues that the practitioner may have a need to understand. Although many issues are beyond the scope of this book, it is the authors' intention to provide a generalized understanding of many of the issues that have an impact on plan design and plan operation, including:

- SEP, SARSEP, and SIMPLE plans
- Profit-sharing plans
- Defined-contribution pension plans
- 401(k) plans
- Defined-benefit plans
- Fully insured IRC Section 412(i) plans
- EPCRS, VFPC, and DFVC
- Deduction issues
- Plan distributions
- Rollovers and portability
- State taxation
- Beneficiary designations
- Form 5500 filing requirements
- ERISA fiduciary considerations
- USERRA
- Nonqualified plans
- Plan administration and fiduciary issues
- Plan asset investment issues
- IRS, PBGC, SEC, and DOL issues and investigations
- Plan reporting and disclosure requirements
- Participation, vesting, and funding issues
- The use of “rabbi” and “secular” trusts

The material presented in this book, however, is not intended to be a complete examination of the area and will not, in and of itself, equip practitioners to design and administer these plans on their own. The text is not intended to replace or circumvent the need to retain competent legal advice, plan advisers, consultants, and/or administrators, or to circumvent the procedures for obtaining rulings and technical advice.

Retirement Terminology

Many areas of the law, particularly tax law, have their own language. The retirement planning area is no exception. Many terms-of-art have particular, and often peculiar, meanings that may not be apparent. It is for this reason that the authors have gone to great lengths to define and explain terms such as:

- Highly compensated employees
- Key employee
- Accrued benefit
- Administrator
- Beneficiary
- Employee
- Employer
- Fiduciary
- Hybrid plans
- Limitation year
- Normal retirement age
- Participant
- Plan sponsor
- Plan year

Plan Updates, Review, and Maintenance

Initially, a company retirement plan may be updated periodically, as implementation proceeds. Once the plan is in motion, and all parties are satisfied with its progress, the plan must be reviewed at least annually, and updated as necessary. The practitioner must work closely with the client in order to make sound business and personal decisions.

Clients need guidance more than ever, given the combination of never-ending tax reform, the Internal Revenue Code's significant and complex changes, and the market volatility experienced over the past few years. Practitioners who provide this level of planning and review will help clients by:

- Making annual assessments of their retirement plans.
- Identifying weaknesses and recommending solutions.
- Educating clients about the process.
- Identifying ways to mitigate tax liability.
- Analyzing clients' needs and goals.
- Ensuring that clients' objectives are being achieved.

Practice Pointer: Throughout the text, we have provided you with numerous "Practice Pointers," "Notes" and "Cautions." These paragraphs spotlight areas in which you will interact with your client and draw attention to actions, activities, or information that you should be aware of to ensure competent and comprehensive client service.

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Chapter 1

Introduction

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Simply stated, the best retirement plan is the one that comes closest to satisfying the needs and objectives of the client, the adopting employer. Matching those needs to the various types of available plans and the myriad possible plan designs is often more difficult than defining the employer's needs and objectives. The benefits and costs associated with establishing, maintaining, and terminating the plan, and the life of the plan must all be considered. The motivation of the employees and the demographics of an employer may also be relevant factors in choosing the right plan. (See Appendix A, "Charts and Tables," for plan comparison and other useful charts. Appendix D, "Employee Benefits and Related Limits," provides a table of indexed employee benefit and other limits for several years.)

For example, a simplified employee pension plan (SEP) program can compare favorably with a qualified plan even though fully vested SEP contributions would generally be made for transient employees with *three* or more years of service. A qualified plan's shorter eligibility requirement (generally, a service requirement of one year and 1,000 hours) *may* result in contributions having to be made or allocated to more employees. Although the qualified plan would most likely have a vesting schedule applied to employer-derived accrued benefits or account balances, it is applied to an additional two years of contributions made by the employer. The plan that offers the least employee cost at all points along an employee's employment time line can be determined only after:

- Considering many factors, such as potential growth of business, employee turnover, age, whether employed on the last day of the plan year, worked at least 500 or 1,000 hours, work patterns, and so on.
- Analyzing a group's eligibility to participate initially and then to receive contributions, and the extent to which those contributions will be vested upon an employee's termination of service.

Designing the Best Plan

The right plan can be selected by design, but the decision often involves the elimination of unsuitable plan types followed by the selection and design of the best plan from those that remain. For example, an employer

that is unable to commit to a contribution level would not ordinarily adopt a pension plan. A 401(k) plan would not be suitable for a smaller business owner if nonhighly compensated employees (NHCEs) choose not to make elective contributions. A SEP may be more suitable for a smaller business owner if there is high turnover in early years. It is generally better not to make a contribution for an employee than to rely on a vesting schedule or forfeiture provision.

Nonqualified deferred compensation plans should also be considered. In some cases, a nonqualified deferred compensation plan may be more appropriate in satisfying an employer's needs and objective. See Chapter 25, "Missing Participants, Beneficiaries, and Alternate Payees."

The funding of plan benefits is generally accomplished by investing in securities, as opposed to or in addition to life insurance, guaranteed investment contracts, annuities, and real estate. If an individual provides advice on such matters, they may have to be registered as an investment adviser.¹ If life insurance is purchased in a qualified plan, numerous tax and nontax issues also need to be considered.

In addition to providing information on qualified and tax sanctioned plans in general, this book focuses on aspects of plan design for the smaller business owner. In addition, numerous chapters are devoted to other issues that the practitioner may need to understand. Although many issues are beyond the scope of this book, it is the authors' intention to provide a generalized understanding of many of the issues that have an effect upon plan design and general operation of a plan.

The design of cross-tested plans is both an art and a science. The enormous complexity of the IRS regulations in this area provides both opportunities and pitfalls for the practitioner. The need to have competent assistance on an initial and ongoing basis cannot be overemphasized. This is not an area in which the intelligent practitioner can afford to go it alone. The risk of mistakes being made is high and the penalty can be catastrophic, for both the client and the practitioner.

The material presented in this book is far from a complete examination of this area and will not, in and of itself, equip practitioners to design and administer these plans on their own. It is a wise individual who knows his or her limitations and calls in the artillery if appropriate. This book is not intended to replace or circumvent the need to retain *competent* legal advice, plan advisers, consultants, and/or administrators, or circumvent the procedures for obtaining ruling and technical advice.

Definitions

Many of the terms used throughout this book have special meanings, as given in the following alphabetical list. Note, especially, the definitions for frequently used terms, including *highly compensated employee (HCE)* and *key employee*. For some terms, the definitions include commentary and examples.

Accrued Benefit

The meaning of the term *accrued benefit* is determined by the type of plan, as follows:

1. In a traditional *defined benefit plan*, the individual's accrued benefit determined under the plan is generally expressed in the form of an annual benefit commencing at normal retirement age. Thus, the

¹ See Investment Advisers Act of 1940, Section 202(A)(11). See especially, Securities and Exchange Commission Release No. IA-1092, Part II(A)(1) (Oct. 8, 1987), penultimate sentence.

accrued benefit is the portion of an employee's normal retirement benefit that he or she has earned at a given point in his or her career.²

Example. For example, if an employee enters a 1 percent final average pay plan at age 30, works until age 40, and earns average monthly pay of \$2,000, that employee's accrued benefit might be \$200 ($1\% \times \$2,000 \times 10$ years). If the same employee works until age 55 and his or her average monthly pay increases to \$3,000, the accrued benefit would increase to \$750 ($1\% \times \$3,000 \times 25$ years).

2. In an *individual account plan*, the balance of the individual's account is the accrued benefit.³ A *defined-contribution plan* is an individual account plan. The following example is based on such a plan:

Example. Aggregate contributions allocated to Kitty's qualified plan profit-sharing account totaled \$300,000, and the account currently has a fair-market value (FMV) of \$200,000. The account is 50 percent vested. Kitty's accrued benefit is \$200,000 (the value of her accounts under the plan); her vested accrued benefit is \$100,000 ($\$200,000 \times .50$).

3. Under a statutory hybrid plan (for example, *cash balance* or *pension equity plan*), the accrued benefit is the employee's account balance. The following is an example:

Example. An employee receives an allocation equal to 5 percent of pay each year he or she works, and the employee's account is credited with interest at 5 percent, compounded annually, until it is paid.

Actuarially Equivalent

Benefits payable at different times or in different forms are actuarially equivalent if they are of equal value, based on certain assumptions. The plan specifies the assumptions that are used to calculate actuarially equivalent benefits. The two assumptions most often used to compare the value of one benefit to another are interest (which is used to measure the value of receiving a payment earlier instead of later) and mortality (which is used to measure the probability that the recipient will live to receive a given payment).

Administrator

The *administrator* is the person specifically so designated by the terms of the instrument under which the plan is operated; if an administrator is not so designated, the plan sponsor, or in the case of a plan for which an administrator is not designated and a plan sponsor cannot be identified, such other person in accordance with Department of Labor (DOL) regulations.⁴

Annual Addition

The term "annual additions" generally means the sum for any year of employer contributions, employee contributions, and forfeitures. In addition to applying to qualified defined contribution plans, the limitations on defined contribution plans apply to section 403(b) annuity contracts, simplified employee pensions described in section 408(k), mandatory employee contributions to qualified defined benefit plans, and contributions to certain medical accounts.⁵

² IRC Section 411(a)(7)(A)(i); see too, 29 USC 1002(23)(A).

³ IRC Section 411(a)(7)(A)(ii); see too, 29 USC 1002(23)(B).

⁴ 29 USC 1002(16).

⁵ I.R.C. Section 415(c)(2).

Beneficiary

The *beneficiary* is a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder.⁶ See Chapter 21, “Beneficiary Designations.”

Cash Balance Plan

Although still called a *cash balance plan* by most practitioners, the Department of Labor, and the Pension Benefit Guarantee Corporation (PBGC), this type of plan is more technically called a “statutory hybrid plan” or “applicable defined benefit plan.” In general, a cash balance plan is a defined benefit plan that generally defines an employee’s benefit as the amount hypothetically accrued or credited to an account (for example, lump sum based plan). See Hybrid Plan below.

Defined Benefit Plan

The term *defined benefit plan* means a pension plan other than an individual account plan. Nevertheless, a pension plan, which is not an individual account plan and provides a benefit derived from employer contributions based partly on the balance of the separate account of a participant, is treated as an individual account plan to the extent benefits are based upon the separate account of a participant, and as a defined benefit plan with respect to the remaining portion of benefits under the plan.⁷

Defined-Contribution Plan

The term *defined-contribution* (or *individual account plan*) means a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant’s account; and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.⁸

Employee

The term *employee* means any individual employed by an employer, and includes an individual who is a self-employed individual for the taxable year.⁹

Employee Pension-Benefit Plan or Pension Plan

The terms *employee pension-benefit plan* or *pension plan* mean any plan, fund, or program which was heretofore, or is hereafter established or maintained by an employer or by an employee organization, or by both. Such a plan is further defined by the extent to which, by express terms, or as a result of surrounding circumstances, such plan, fund, or program provides retirement income to employees, or results in a deferral of income by employees for periods extending to the termination of covered employment or beyond regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan. This is the Employee Retirement Income Security Act of 1974 (ERISA) definition which does not distinguish between plan types.¹⁰ Thus, under ERISA, a profit-

⁶ 29 USC 1002(8).

⁷ 29 USC 1002(35).

⁸ 29 USC 1002(34).

⁹ IRC Section 401(c)(1)(A).

¹⁰ 29 USC 1002(32)(A).

sharing or SEP plan may be a *pension plan*. Except as necessary, the more familiar terms (money purchase, profit sharing, and so on) are used in this book.

Employer

The term *employer* means any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity.¹¹

Excess-Benefit Plan

The term *excess-benefit plan* means a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by Internal Revenue Code (IRC) Section 415.¹²

Fiduciary

A person is a *fiduciary*¹³ with respect to a plan to the extent he or she can perform any of the following:

1. Exercise any discretionary authority or discretionary control respecting the management of such plan or exercise any authority or control respecting the management or disposition of its assets.
2. Render investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or assume any authority or responsibility to do so.
3. Assume any discretionary authority or discretionary responsibility in the administration of such plan. There are exceptions for investment companies and investment managers in which money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 (that is, a mutual fund).

Highly Compensated Employee

For plan years beginning after 1996, a *highly compensated employee* (HCE) is either of the following:¹⁴

1. A 5-percent owner at any time during the current or preceding year, or
2. An individual who had compensation from the employer exceeding \$100,000 (the 2006 and 2007 limits) for the preceding year and was in the top-paid group

The employer may elect to limit highly compensated treatment for a year to employees who were in the top-paid group of employees for that year (see the following discussion). Any employee who is not a highly compensated employee is a nonhighly compensated employee (NHCE).

The applicable dollar amount (currently \$100,000) for a particular plan year (current year) or look-back year (that is, preceding year) is the dollar amount for the calendar year in which the plan year or look-back year begins. Compensation, for this purpose, is the compensation received by the employee from the employer for the year, including elective or salary-reduction contributions to a cafeteria plan, cash or deferred

¹¹ 29 USC 1002(5).

¹² 29 USC 1002(36).

¹³ IRC Section 4975(e).

¹⁴ IRC Section 416(i)(1)(B)(i).

arrangement, or tax-sheltered annuity.¹⁵ The rule requiring the highest paid officer to be treated as an HCE was repealed for plan years beginning after 1996.

In general, the top 20 percent of employees, ranked by compensation paid during a given year, are considered members of the top-paid group once the top-paid group election is made or once the SEP document makes the election automatic.¹⁶ An employer may make a top-paid group election in its plan document. Once such an election is made, it will apply to all future years unless changed by the employer. Furthermore, if such an election is made, only 5-percent owners and employees in the top-paid group are considered HCEs.¹⁷ An employer should keep track of whether the top-paid group election applies and, if so, to which years the election applies for purposes of making amendments in the future.

Hybrid Plan

A plan that defines an employee's accrued benefit as a single sum is sometimes called a *hybrid defined benefit plan*, since it combines the appearance of a defined-contribution plan with the security of a defined benefit plan. Technically, this type of plan is called a "statutory hybrid plan"¹⁸ or "applicable defined benefit plan."¹⁹ Both terms mean the same thing. Failure to qualify as such, may result in age discrimination issues (see Caution below). Exhibit 1–1 shows the various terms for hybrid plans that have evolved and take into account the changing terminology reflected in the Code brought about by the Pension Protection Act of 2006 (PPA)²⁰ and Notice 2007-6.²¹ The Notice provides guidance which relates to cash balance plans and other hybrid defined benefit pension plans and to amendments that convert defined benefit pension plans to hybrid defined benefit pension plans.

A *cash balance plan* is a type of statutory hybrid plan. Another type of hybrid defined benefit plan is a *pension equity plan*, which accumulates pension credits and applies them to an employee's pay to calculate a single-sum benefit. Other types include a personal account plan, life cycle plan, and a cash account plan.

A hybrid defined benefit plan must generally comply with the same requirements that apply to other defined benefit plans, including the rules that govern vesting, funding, and payment of benefits. All hybrid defined benefit plans are required by law to offer annuities. If an employee is married, a hybrid plan automatically pays the employee's retirement benefit as an annuity for the joint lives of the employee and his or her spouse, unless the employee elects another form of payment and the spouse consents.

A statutory hybrid plan either satisfies the special rules relating to age under IRC Section 411(b)(5)(B),²² discussed below, or is a lump sum based plan or a plan that has the effect of a lump sum based plan.

A *lump sum based plan* is a defined benefit plan where the "accumulated benefit" is expressed as the balance of a hypothetical account or as the current value of the accumulated percentage of the participant's final average compensation (or a plan where the accrued benefit is the actuarial equivalent of a hypothetical account balance or accumulated percentage). A lump sum plan does not need to offer a lump sum as an optional form of benefit.²³

¹⁵ Temp. Treas. Reg. Section 1.414(q)-1T, Q&A-3(c)(1), Q&A-13.

¹⁶ IRC Section 414(q)(3).

¹⁷ IRS Notices 97-45 (1997-2 CB 296), 98-1 (1998-1 CB 610).

¹⁸ IRS Notice 2007-6, Section III(A), 2007-3 IRB 272; IR 2006-193 (Dec. 21, 2006).

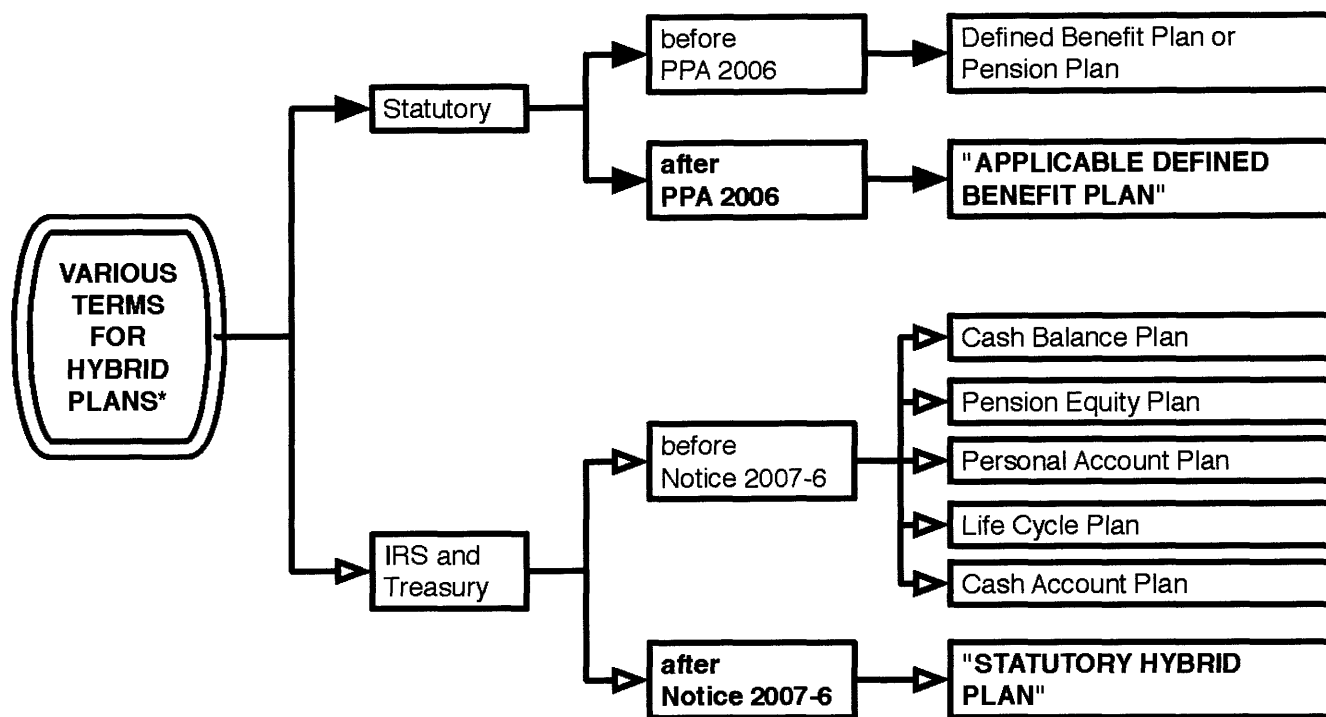
¹⁹ See IRC Section 411(b)(5)(B), as amended by the PPA (2006).

²⁰ PPA §§ 701, 702 (P.L. 109-20) (H.R. 4, signed into law on August 17, 2006).

²¹ IRS Notice 2007-6, Section III(A), 2007-3 IRB 272; IR 2006-193 (Dec. 21, 2006).

²² Such a plan must also comply with age discrimination rules under IRC § 411(b)(5)(A) regarding equal or greater accrued benefits than younger similarly situated employee's accrued benefits. This requirement is not mentioned in Notice 2007-6.

²³ IRS Notice 2007-6, Section III(A)(1), 2007-3 IRB 272; IR 2006-193 (Dec. 21, 2006).

Exhibit 1-1. Hybrid Plan Breakdown

Note: Most Practitioners, the DOL and the PBGC will likely continue calling them "Cash Balance Plans" for the foreseeable future

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The *accumulated benefit* is the participant's benefit, accrued to date, whether expressed as an annuity payable at normal retirement age (NRA), the balance of a hypothetical account or the current value of the accumulated percentage of the employee's final average compensation.

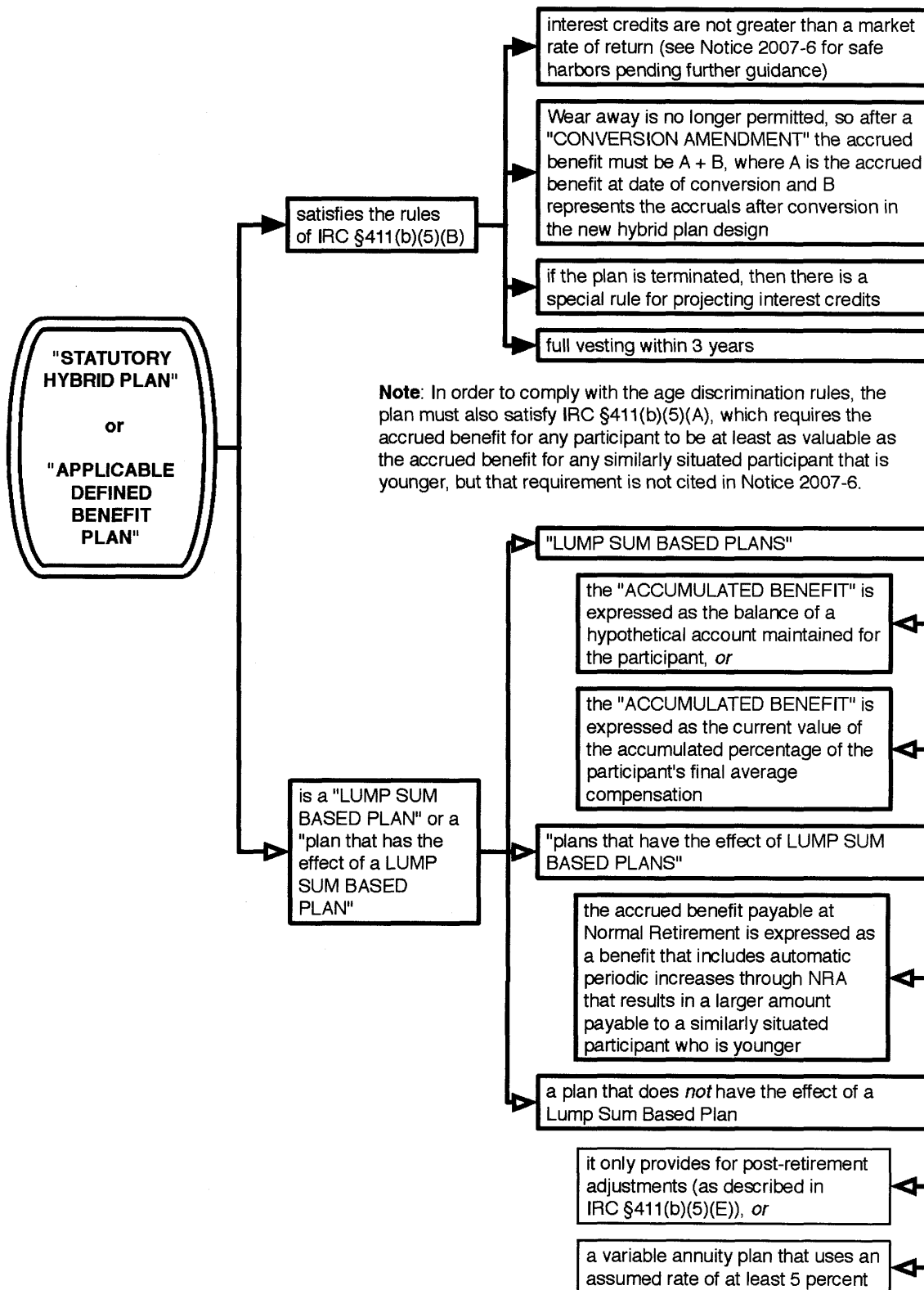
A plan is considered to be similar to a "lump sum based plan" if an accrued benefit payable at NRA is expressed as a benefit that includes automatic periodic increases through NRA, and those results in a larger amount payable to that participant than to a similarly situated participant who is younger.²⁴ However, a plan that solely provides for post-retirement adjustments,²⁵ or a variable annuity plan that uses an assumed interest rate of at least 5 percent, is *not* treated as having a similar effect to a lump sum based plan.²⁶ Exhibit 1-2 reflects the general requirements for a "hybrid plan" to satisfy the requirements of IRC Section 411(b)(5)(b) or to be considered "lump sum based."

²⁴ IRS Notice 2007-6, Section III(A)(2)(i), 2007-3 IRB 272; IR 2006-193 (Dec. 21, 2006).

²⁵ As described in IRC Section 411(b)(5)(E).

²⁶ IRS Notice 2007-6, Section III(A)(2)(ii), 2007-3 IRB 272; IR 2006-193 (Dec. 21, 2006).

Exhibit 1-2. A Lump Sum Based Plan



A *variable annuity plan* includes any plan where the amount payable is periodically adjusted by reference to the difference between the assumed rate of return and the actual rate of return of the plan assets or a specified market index.²⁷

Special rules apply if a defined benefit plan is converted to a statutory hybrid plan after June 29, 2005. If such a plan is ever terminated then it must comply with a special rule for projecting variable crediting rates.²⁸

Caution: *Age discrimination under “statutory hybrid plans” remains a concern for hybrid plans that existed before the passage of the PPA on August 17, 2006. The provisions under the PPA allowing a “lump sum based plan” to determine the “accumulated benefit” for a participant either as his or her hypothetical account balance or as his or her accumulated percentage of average salary does not have retroactive effect.*

Note. Notice 2007-6 also provides interim guidance for conversions related to mergers and acquisitions, in the form of a safe harbor. Pending further guidance (expected to be published by August 2007), an amendment that converts a defined benefit plan into a hybrid plan with respect to a group of individuals who become employees by reason of a merger, acquisition, or similar transaction will be deemed to satisfy the age discrimination requirements²⁹ if the benefit for each participant is at least the sum of his protected accrued benefit on the date before the plan amendment and his protected accrued benefit earned for service after the amendment.³⁰

Notice 2007-6³¹ also provides guidance on “conversion amendments.” A *conversion amendment* is any amendment after June 29, 2005, that converts a traditional defined benefit plan to a “statutory hybrid plan.”

A *moratorium plan* is a converted cash balance plan that was seeking a determination letter in 1999 when the IRS placed a moratorium on issuing letters for such plans. The PPA specifically stated that the new age discrimination rules³² have absolutely no retroactive effect. As shown in Exhibit 1–3, for purposes of determination letter requests, a conversion before June 30, 2005, will be reviewed, but cannot be relied upon, as to whether the conversion satisfies the age discrimination rules; whereas, a conversion after June 29, 2005, will be reviewed, and can be relied upon as to whether the conversion amendment complies with the requirements for all statutory hybrid plans, including age discrimination rules.³³

²⁷ Id. Section § III(A)(2)(ii)(II).

²⁸ See IRC Section 411(b)(5)(B)(ii), (iii), and (vi). Pending subsequent guidance, as a safe harbor, a plan can credit the rate of interest either on long-term investment grade corporate bonds (that is, the special permissible range for the 2004 through 2007 minimum funding standard account, if used by the hybrid plan before 2008, or the newly introduced third segment rate for funding, if used by the hybrid plan after 2007), or on the rate of interest on 30-year Treasury securities (*that is*, the pre-PPA rate used for lump sum distributions under IRC Section 417(e)(3)). Further, the safe harbor protection in the Notice 2007-6, 2007-3 IRB; IR 2006-193 (Dec. 21, 2006) allows a hybrid plan to credit interest based on the sum of any of the standard indexes and the associated margin for that index (in accordance with the rules previously stated in Notice 96-8, 1996-1 CB 359).

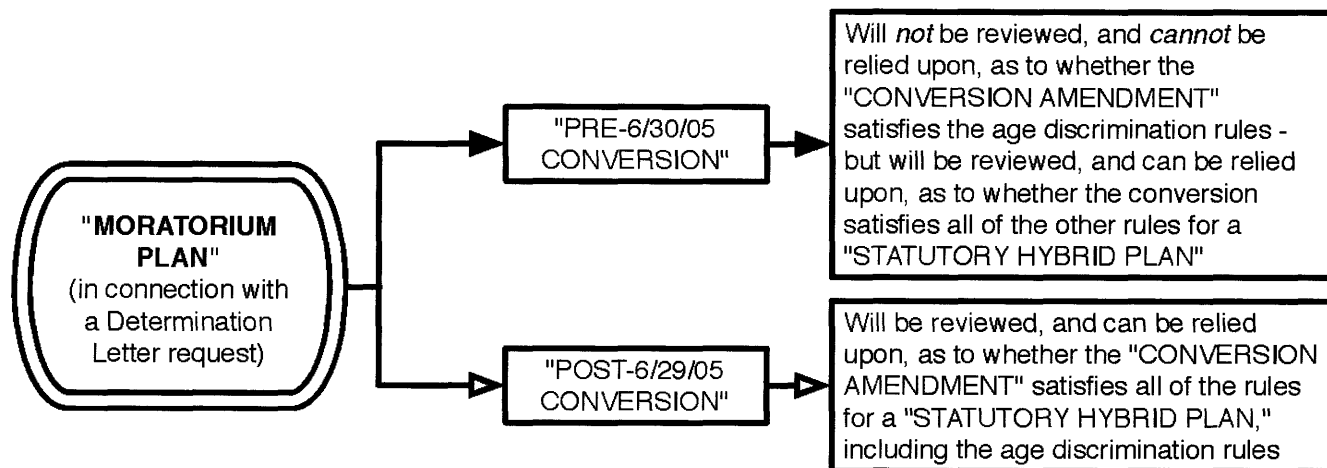
²⁹ See IRC Section 411(b)(1)(H).

³⁰ Notice 2007-6, Section III(F)(2), 2007-3 IRB 272; IR 2006-193 (Dec. 21, 2006)

³¹ Notice 2007-6, Section III(E), 2007-3 IRB 272; IR 2006-193 (Dec. 21, 2006).

³² See IRC Section 411(b)(1)(H).

³³ IRS Notice 2007-6, § IV(A)(2) and (3), 2007-3 IRB 272; IR 2006-193 (Dec. 21, 2006).

Exhibit 1–3. A Moratorium Plan

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Note. *Target-benefit plans*, in which the actual pension is based on the amount in the participant's account, are treated as defined-contribution plans. Hybrid plans, which are part target- and part defined benefit, are treated as defined-contribution plans to the extent that benefits are based on the individual account.

Key Employee

For plan years beginning after 2001, an employee is considered a *key employee* if, during the plan year, he or she was one of the following:³⁴

- An officer with compensation in excess of \$145,000 (the 2007 limit) as, adjusted for cost-of-living adjustments (COLAs) in \$5,000 increments³⁵
- An owner of more than 5 percent, or
- A more than 1-percent owner with compensation in excess of \$150,000

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) eliminated the 4 year look-back and the top 10 owner rules. The family ownership attribution rules under IRC Section 318,³⁶ however, apply in determining whether an individual is a more than 5 percent owner of the employer for purposes of these rules.³⁷ There is no *age 21* rule or exception under the IRC Section 318 attribution rules. This issue is more fully discussed in Chapter 2, "Simplified Employee Pension Plans — SEP and SARSEP."

³⁴ IRC Section 416(i).

³⁵ See IR-2006-162 (October 18, 2006).

³⁶ See, S. Derrin Watson, "Who's The Employer," a guide to employee and aggregation issues affecting qualified plans and SEPs, Qs 14:1-4:17 (4th Ed, 2005) at <http://www.employerbook.com/WTE4/>.

³⁷ IRC Sections 408(k)(6)(G); 416(i)(1)(A) and (B).

Limitation Year

For a defined contribution plan, the limitation year is the basis for measuring the annual addition limits under IRC Section 415(c) and the maximum annual benefit limitations for defined benefit plans under IRC Section 415(b).

The *limitation year* is the calendar year unless another 12-month period is designated in the plan document. (Nearly every plan will designate the plan year as its limitation year.) For limitation years that begin after December 31, 2001, the maximum annual addition to a defined contribution plan (including a SEP or SARSEP) is the lesser of 100 percent of compensation or \$45,000 (the 2007 limit), plus catch up contributions if age 50 or older).

Nonforfeitable

The term *nonforfeitable*, when used with respect to a pension benefit or right, means a claim obtained by a participant or his beneficiary to that part of an immediate or deferred benefit under a pension plan which arises from the participant's service, which is unconditional, and which is legally enforceable against the plan.³⁸

Normal Retirement Age

The term *normal retirement age* means the earlier of the time a plan participant attains normal retirement age under the plan, or the later of the time a plan participant attains age 65, or the fifth anniversary of the time a plan participant commenced participation in the plan.³⁹

Normal Retirement Benefit

The term *normal retirement benefit* means the greater of the early retirement benefit under the plan, or the benefit under the plan commencing at normal retirement age. The normal retirement benefit is determined without regard to medical benefits, and most disability benefits.⁴⁰

Participant

The term *participant* means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.⁴¹

Plan Sponsor

The term *plan sponsor* means the employer in the case of an employee benefit plan established or maintained by a single employer, the employee organization in the case of a plan established or maintained by an employee organization, or in the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan.⁴²

³⁸ 29 USC 1002(19).

³⁹ IRC Section 401(a)(14); see too, 29 USC 1002(24).

⁴⁰ Id.

⁴¹ 29 USC 1002(7).

⁴² 29 USC 1002(15)(B).

Plan Year

The terms *plan year* and *fiscal year* of the plan mean, with respect to a plan, the calendar, policy, or fiscal year on which the records of the plan are kept.⁴³

Top-Heavy Plan

A smaller business owner is not likely to establish a plan that is not top heavy. A plan that is intended to be funded solely with elective contributions may be top heavy and then require additional employer-derived contributions. A plan is top heavy when it primarily benefits key employees.⁴⁴

A qualified defined-contribution plan or SEP that primarily benefits key employees as of the determination date is top heavy and becomes subject to the top-heavy rules of the IRC. A defined-contribution plan is top heavy when it benefits key employees when 60 percent or more of the aggregate account balances under the plan as of the determination date belong to key employees.⁴⁵

Special rules allow an employer to determine whether a SEP or SARSEP arrangement is top heavy for any plan year by taking into account aggregate contributions rather than by taking into account aggregate account balances of all employees.⁴⁶

Determination Date

Generally, the determination date for determining whether a plan is top heavy is the last day of the preceding plan year. In the case of the first plan year of any plan, the determination date is the last day of that plan year; however, contributions made after the determination date that are allocated as of a date in that first plan year are not considered.⁴⁷ When calculating a participant's account balance for the purpose of determining whether a plan is top heavy, the account balance is increased for distributions made to the participant within the five-year period (which, after 2001, is generally reduced to a one-year look-back period) ending on the determination date.⁴⁸ The five-year period is retained unless the distribution is made because of severance from employment, death, or disability.

When a qualified plan or SEP is top heavy, the employer must make a minimum contribution for each eligible nonkey employee that is equal to the lesser of the following:

1. Three percent of each eligible nonkey employee's compensation
2. A percentage of each eligible nonkey employee's compensation equal to the percentage of compensation at which elective and nonelective contributions are made under the plan (and generally under any other plan maintained by the employer) for the year for the key employee for whom the percentage is the highest for the year⁴⁹

Example. An employer makes contributions of 6 percent of compensation to each eligible employee's account under the plan. Assuming the plan was top-heavy, the minimum required contribution amount (3 percent) has already been contributed. No further contributions are required.

⁴³ 29 USC 1002(39).

⁴⁴ Treas. Reg. Section 1.416-1, Q&A G-1.

⁴⁵ IRC Section 416 (g)(1)(A)(ii).

⁴⁶ IRC Section 416(i)(6)(B).

⁴⁷ IRC Section 416(g)(4)(C); Treas. Reg. Section 1.416-1(b), Q&A T-24.

⁴⁸ IRC Sections 408(k)(1)(B), 416(g)(3).

⁴⁹ IRC Sections 408(k)(1)(B), 416(b)(2).

Example. An employer makes contributions of 2 percent of total compensation plus 4 percent of compensation in excess of \$50,000 under an integrated plan to each eligible employee's account under the plan (see Chapters 3 and 7). Assuming the plan was top-heavy, each non-key employee must receive an additional contribution (for example, 1 percent) as described above.

Special rules apply to salary reduction simplified employee pension plans (SARSEPs) (see Chapter 2).

Elective contributions may not be used to satisfy an employer's top-heavy contribution requirement.⁵⁰ In most cases, contributions made under other plans maintained by the same employer may also have to be considered.

Similar rules apply to defined benefit plan, except that the determination is based on benefits rather than contributions, and minimum benefits must be provided to nonkey employees.

⁵⁰ IRC Sections 408(k)(6)(D), 416(c)(2); Form 5305A-SEP, Top-Heavy Requirements, at 4; Treas. Reg. Section 1.401(k)-1(a)(6)(i)(C).

Chapter 2

Simplified Employee Pension Plans— SEP and SARSEP

An employer may establish a simplified employee pension plan (SEP) under which it can contribute relatively large amounts to its employees' individual retirement accounts or annuities (IRAs). The employer (and, in some instances, the employees themselves) may make much larger contributions to the employees' IRAs under a SEP than employees could make to their IRAs under the normal IRA rules. For 2007, the maximum amount that can be contributed by an employer, including elective deferrals, is \$45,000 (\$50,000 with a catch-up contribution for participants age 50 or older). All SEP contributions are made into traditional IRAs, commonly referred to as SEP IRAs, which are generally established by eligible employees. A SEP established before 1997 may include provisions allowing employees to make pretax (elective) contributions under the plan to reduce their compensation subject to federal (and, in some cases, state) income tax. Such a plan is referred to as a salary-reduction or elective SEP (SARSEP or grandfathered SARSEP).

Caution: *Although EGTRRA generally increased deductible SEP contribution limits to 25 percent of the aggregate preplan compensation of participating employees, the amount that may be excluded from a participant's income (25 percent as a result of the JCWAA) is based on includable compensation. Catch-up contributions are separately deductible. As a consequence, SARSEP plan is generally designed around the exclusion limit rather than the higher deduction limit.¹*

Establishing a SEP

An employer must establish its SEP and make its contributions to IRAs established by eligible employees. The SEP and the IRAs must be established by the due date of the employer's federal income tax return for the tax year to which the contribution is related (including extensions).² A group trust may be established by an employer for holding the asset of the IRAs of its participating employees.³ In establishing a SEP, an employer may use the model SEP of the IRS, an IRS approved prototype SEP, or an individually designed SEP.

¹ IRC Sections 402(h)(2)(B), 404(h)(1)(B), 404(n).

² IRC Section 404(h)(1)(B).

³ IRC Section 408(c).

The term *employer* includes all related employers. *Related employers* are either members of an affiliated service group, a controlled group of corporations, or a trade or business under common control.⁴ All related employers should adopt the employer's SEP plan by affixing their signatures to the SEP plan agreement (and by adopting a written resolution if necessary).

An exception is provided, however, if an employer becomes or ceases to be related. The exception only applies during the transition period which begins on the date of the change in members of the group and ends on the last day of the first plan year beginning after the date of such change. In general, if the coverage requirements were satisfied before each change and coverage under the plan is not significantly changed during the transition period (other than change by reason of the change in members of the group), the participation rules will continue to be satisfied during the transition period.⁵

IRS Model SEP

The simplest method by far for adopting a SEP is for the employer to adopt the IRS model plan, by executing IRS Form 5305-SEP, Simplified Employee Pension Individual Retirement Accounts Contribution Agreement, and/or model Form 5305A-SEP, Salary Reduction Simplified Employee Pension Individual Retirement Accounts Contribution Agreement. To adopt the IRS model SEP, an employer must meet all of the following requirements:

1. The employer must not maintain any other qualified retirement plan. (A terminated plan is not taken into account.)
2. IRAs must have been established for all eligible employees. An employer can require that employees establish IRAs for their own benefit; an employer can even establish IRAs on its employees' behalf if the employees refuse to do so for themselves or if any employee cannot be located.
3. The employer must not be a member of a controlled group of corporations; a trade, or business under common control; or an affiliated service group unless all eligible employees of all the members of the group, trade, or business participate in the SEP.
4. The employer must pay the cost of SEP (but not SARSEP) contributions.
5. Although an employer need not make a contribution for any particular year, for years in which it does contribute, the contribution percentage must be identical with respect to each employee. In other words, under the model forms, contributions may not be integrated with Social Security.
6. The employer does not use the services of a leased employee.
7. The employer does not have more than 25 employees eligible to participate in a SARSEP at any time during the prior calendar year (SARSEP only).
8. The employer is not a state or local government (SARSEP only).
9. The employer has any eligible employees whose taxable year is not the calendar year (prototype SARSEP only).
10. Compensation after reduction for elective contributions will be used for allocating employer contributions.⁶ See "Caution" below.

⁴ IRC Section 414(b), 414(c).

⁵ IRC Section 410(b)(6)(C); see Rev. Rul. 2004-11 (2004-1 CB 480) regarding the transition rule on a pension and profit-sharing plan following a sale of subsidiary stock to an unrelated employer.

⁶ See Instructions, IRS Form 5305A-SEP, Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement, SEP Requirements," page 3.

Model SARSEP

To establish an IRS model SARSEP, an employer adopts IRS Form 5305A-SEP. An employer must also adopt IRS Form 5305-SEP in order to make contributions other than top-heavy contributions and employees' salary-reduction contributions. An employer's eligibility to adopt the IRS model SARSEP is subject to the limitations described above for adopting Form 5305-SEP. If any key employee participates in a SARSEP, the employer must make a top-heavy minimum contribution but not more than 3 percent of each nonkey employee's plan year compensation.⁷ Alternatively, an employer may make the required top-heavy contribution to all participants eligible to make elective contributions.

When the model SEP forms (Form 5305-SEP and Form 5305A-SEP) were revised in March 2002, employers were required to amend their existing model SEP and model SARSEP (for EGTRRA and the required minimum distribution regulations) and adopt the amended plans no later than December 31, 2002. The IRS required an employer's execution of the amended 2002 model plan documents. A mere mailing of an amendment to existing forms to plan adopters was not sufficient.⁸

The model SEP form (Form 5305-SEP) was revised again in December 2004 and the model SARSEP (Form 5305A-SEP) in June 2006. If an employer used the March 2002 version of Form 5305-SEP or Form 5305A-SEP it is *not* required that the employer execute this version of the forms.

Caution: *An example in a joint IRS/DOL publication shows that in computing the individual percentages deferred by each NHCE for purposes of the 125 percent ADP test, compensation is not reduced by elective deferrals. After discussing the model SEP and SARSEP forms, the example shows a 4 percent deferral rate for an individual that made \$400 in elective deferrals (not including catch-up elective deferrals) from gross earnings of \$10,000 (rather than 4.167 percent (\$400 divided by \$9,600 of net compensation). Furthermore, the definitions of compensation found in the model SEP and updated "grandfathered" model SARSEP differ, and in some cases conflict, as they are intended to be used together. Sponsors using a prototype SARSEP document will generally avoid conflicting definitions of compensation.*

Prototype SEP

The second method of establishing a SEP is for an employer to adopt a prototype SEP established by a bank or other permissible financial institution. The prototype plan document normally contains terms similar to those included in the IRS model SEP plan. An employer may normally rely on the IRS opinion letter obtained by the SEP's sponsoring organization, if the employer's contributions to the SEP, when combined with the employer's other retirement plan contributions, do not exceed the limitations of Internal Revenue Code (IRC or the Code) Section 415. No determination letter need (or can) be requested from the IRS by the employer. An employer may, however, request a ruling that its contributions do not exceed the IRC Section 415 limitations, whereby the employer maintains more than one SEP or maintains a qualified plan in addition to a SEP. A prototype SEP may allow for integration with Social Security, integration with noncalendar-year plans, and coordination with another plan.

⁷ Although not mentioned in the model Form 5305A-SEP, top-heavy contributions must be based on compensation that includes elective deferrals. See top-heavy rule of IRC Section 416(i)(1)(D) referring to the meaning, given the term under IRC Section 414(q)(4). In the author's opinion, the definition of compensation found in the model documents is, at best, unclear and could result in lower overall contributions than permitted in a prototype plan.

⁸ Rev. Proc. 2002-10 (2002-4 I.R.B. 401); but see, IRS Ann. 93-8 (1993-3 I.R.B. 61).

Existing prototype SEP plans must be amended, approved, and adopted by the employer within 180 days after such plans receive IRS approval.⁹

***Caution:** The definition of compensation found in a prototype SEP/SARSEP document may or may not include elective deferrals as compensation for allocation purposes.*

Individually Designed SEP

An employer may design its own SEP. As with qualified plans, an employer is not required to obtain a ruling from the IRS that the SEP satisfies the requirements of the Code, but employers frequently choose to do so.¹⁰

Written Allocation Formula

Employer contributions must be determined under a definite written allocation formula that specifies the requirements an employee must satisfy to share in an allocation and the manner in which the amount allocated is computed.¹¹

Vesting

Because employees' accounts are maintained in their own IRAs, employees are fully vested in all amounts contributed on their behalf.¹² An employer cannot withdraw any amount from an IRA, even an amount made in excess of statutory limits.

Employee Eligibility to Participate

An employer has little leeway in choosing those employees to be covered under its SEP. The SEP must cover each employee who has:

1. Attained age 21 by the end of the plan year in which his or her participation began.
2. Has performed service for the employer during at least three of the immediately *preceding* five years.
3. Has received at least \$500 for 2007 (as indexed for inflation) in compensation from the employer for the current plan year.¹³

An employer may set less stringent requirements when completing the SEP adoption agreement. Although part-time employees are eligible to participate, the ability to have participation commence after the third year of service may be a better alternative to the general one year-of-service requirement under a qualified plan.

In making these determinations, all members of the employer's controlled group must be combined, as well as any members of an affiliated service group.¹⁴ Leased employees must be included as well.¹⁵ Union

⁹ Rev. Proc. 2002-10 (2002-4 I.R.B. 401).

¹⁰ Rev. Proc. 83-36 (1983-1 C.B. 763).

¹¹ IRC Section 408(k)(5).

¹² IRC Section 408(a)(4), 408(b)(4).

¹³ IRC Section 408(k)(2).

¹⁴ IRC Sections 414(b), 414(c), 414(m), 414(n).

¹⁵ IRC Section 414(n)(3)(B).

employees whose benefits have been the subject of good-faith collective bargaining, and nonresident aliens with no source of income in the United States, may, however, be excluded.¹⁶

Although leased employees must be included, statutory exclusions allow an employer, if it so chooses, to exclude from participation under its SEP plan the following employees:¹⁷

- Union employees whose benefits have been the subject of good-faith bargaining (and whose bargaining agreement does not require that they participate in the SEP)
- Nonresident aliens with no source of income in the United States

Example. Mary will turn age 21 on December 31, 2007, and works for an employer that maintains a SEP plan on a calendar-year basis. She performed services during 2002, 2003, and 2004, but performed no services during 2005 and 2006. Mary will share in any employer contribution made for the 2007 plan year.

Compensation is not prorated in determining a participant's share in any contributions made by an employer. Service counts no matter how short and need not be in consecutive years. Owners must meet the same requirements specified in the plan that permit nonowner-employees to participate.

To provide participants who are more highly compensated with larger contributions, as a percentage of their compensation, contributions may be integrated with Social Security benefits on nearly the same basis as is permitted for qualified employer defined contribution plans.¹⁸ Integration (permitted disparity) is more fully discussed in Chapter 7, "Permitted Disparity—Integration of Contributions."

Note. Unlike qualified defined contribution plans, in an integrated SEP, the maximum contribution amount (without regard to catch-up contributions, \$45,000 for 2007) is generally reduced. For individuals whose compensation is subject to Federal Insurance Contributions Act (FICA) or Self-Employment Contributions Act (SECA) taxes, the reduction is equal to the integration level (not to exceed the taxable wage base (TWB) of \$97,500 for 2007) multiplied by the rate (technically called the "disparity rate") that individuals whose compensation exceed the integration level are benefited under the plan (not to exceed 5.7 percent). Thus, for example, in an integrated SEP, the maximum excludable contribution (using the maximum disparity rate and an integration level of \$10,000) is \$44,430 (\$45,000 minus (\$10,000 times .057) for 2007.

Service

The term *service* means any work performed for an employer for any period of time, however short; it need not be continuous, and no special number of hours is required. The term is not defined in the Treasury Regulations.

Example. Claude's uncle owns a gas station that is open on Christmas. The business maintains a calendar-year SEP that provides for an employee to perform services for three out of the five prior plan years to participate for the 2007 plan year. Claude pumped gas for his uncle's business on Christmas day in 2002, 2003, and 2004 and earned no compensation until he was formally hired in 2007 when he earned \$10,000 cleaning windshields and changing the air in tires. Claude quit his position in November 2007. Claude is eligible to participate in the SEP for the entire 2007 plan year if he attained age 21 or older on December 31, 2007 (regardless of whether he is employed on that date).

¹⁶ IRC Section 408(k)(2).

¹⁷ IRC Section 408(k)(3)(B).

¹⁸ IRC Section 408(k)(3)(D).

Example. Doris has been performing services for her friend Sol's sole proprietorship during each of last three calendar years on a part-time basis (she receives no compensation). Each year, Doris stuffs and addresses thousands of marketing brochures for Sol's business; signing Sol's name to each one. The following year (year 4), she begins to receive compensation—more than \$500—for her services and attains age 21 on December 31, 2007, the last day of the plan year. Absent an exclusion (for example, nonresident alien, collectively-bargained), Doris is eligible to participate in Sol's SEP, and receive a contribution if any are made in 2007, because she has met all three participation requirements (age, service, and minimum compensation). The same result would occur if Doris quit or is discharged at any time during 2007 after earning at least \$500.

An owner must satisfy the plan's eligibility requirements if the owner is to participate. If a SEP plan is amended to increase the length of service requirement, discrimination is likely to result if HCE participants could not have met the plan's eligibility requirements at the time the plan was originally adopted.¹⁹

Caution: For SEP and SARSEP purposes, all employees of all employers that are related are treated as if employed by a single employer. Special complications arise if an employer maintains more than one SEP agreement and/or makes contributions to a qualified plan. Discriminatory allocations, differing eligibility conditions, or different investment alternatives available under the plan could cause the plan to run afoul of IRS rules.

The employer maintaining the plan is treated as the plan administrator for Employee Retirement Income Security Act of 1974 (ERISA) purposes.

Suitability

A SEP may be established by an employer of any size. The following types of business entities may establish a SEP:

- Corporations
- S corporations
- Sole proprietors (those who own the entire interest in an unincorporated trade or business operated for profit)
- Nonprofit and government entities (SARSEP are not available.)
- Limited liability companies (LLCs)
- Limited liability partnerships (LLPs)

General Limitations

There are no fewer than four limits that may apply to a SEP, eight limits if the plan is an SARSEP:

1. *The 25 percent participant exclusion limit.* Contributions allocated to an individual's SEP IRA may not exceed 25 percent (15 percent prior to 2002) of that participant's includable (that is, taxable)

¹⁹ See Rev. Ruls. 73-382 (1973-2 CD 134), 70-75 (1970-1 CB 94).

compensation. In addition to this exclusion limit, a participant may exclude from gross income any catch-up contributions, but not other elective deferrals.²⁰ This limit is computed based on the limitation year of the plan (generally the plan year).

Note. Catch-up contributions are treated as includable compensation for purposes of the 25 percent of includable compensation participant exclusion limit. Catch-up contributions are separately excludable from gross income.

Note. Catch-up elective contributions do not reduce the base on which the 25 percent participant exclusion limit is calculated.²¹

2. *The 25 percent deduction limit.* Within limits, all SEP contributions are deductible. The deduction limit (25 percent after 2003) is based on the aggregate compensation (up to \$225,000 for each participant for 2007) without reduction for elective deferrals.²² In addition, elective and catch-up contributions are separately deductible by the employer beyond the 25 percent deduction limit. Contributions that exceed the deduction limit may be subject to a cumulative nondeductible excise tax penalty of 10 percent.²³ This limit is computed using the compensation for the calendar year that ended with or within the plan year.

Caution: Contributions, although deductible, may be includable in a participant's gross income to the extent the amount allocated exceeds the participant's 25 percent exclusion allowance (see item 1) or other limit.

Currently, an employer may make a contribution on behalf of domestic and similar workers (other than the employer or a member of the employer's family). The employer, however, is not afforded a deduction because the contributions are not made in connection with a trade or business. As a result, the 10 percent excise tax on nondeductible contributions will most likely apply to such contributions. It should be noted that a savings incentive match plan for employees (SIMPLE) IRA is not subject to the 10 percent penalty tax on nondeductible contributions involving domestic and similar workers.²⁴

3. *The \$45,000 IRC Section 415 limit.* Contributions, other than catch-up contributions, may not exceed \$45,000 for 2007 (\$44,000 for 2006).²⁵ Contributions that exceed the IRC Section 415 dollar limit are neither deductible by the employer nor excludable from the participant's gross income. Thus, structurally, a SEP participant cannot receive more than \$50,000 (\$45,000 if under age 50 at any time during the calendar in which the plan year ends) for 2007.²⁶ This limit is determined by reference to the annual limit in effect for the calendar year in which the plan year ends. For example, if the SEP's plan year ended in June, the 2007 limit of \$45,000/\$50,000 applies for the 2006-2007 plan year. The \$45,000 limit is reduced slightly when applied to an HCE participating in an integrated SEP. (See Chapter 7.)

²⁰ IRC Section 402(h).

²¹ IRC Section 414(v)(3)(A).

²² IRC Section 402(h).

²³ IRC Sections 4972(a), 4972(d)(1)(A).

²⁴ See IRC Sections 3101, 3111, 3121(a)(7), 3121(a)(10), and regulations thereunder, regarding FICA treatment for payment for services for home worker service, and for services not in the course of an employer's trade or business.

²⁵ IRC Section 415(c)(1)(A).

²⁶ IRC Section 415(j). See, too, Treas. Reg. Section 1.414(v)-1(d)(1) regarding the treatment of catch-up contributions.

4. *The 100 percent of compensation limit.* The total amount of compensation a participant allocates to an SARSEP may not exceed the participant's gross compensation.²⁷

The following limits only apply to a SEP with elective contribution provisions.

5. *The \$15,500 limit on elective deferrals.* A taxpayer's deferral limit under IRC Section 402(g) may not exceed \$15,500 for plan years that end in 2007; \$15,000 for plan years that end in 2006. In addition, up to \$5,000 may generally be contributed as a catch-up elective contribution (for 2006 and 2007) if the individual is age 50 or older on December 31 without exceeding the normal elective limit of \$15,500.

Note. This limit is not reduced by elective contributions made under an eligible 457 plan unless the employers are treated as a single employer because they are controlled or affiliated as discussed above.

Note. If an individual participates in a 403(b) tax-sheltered annuity or custodial account and a qualified plan or SEP, the individual must combine contributions made to the 403(b) plan with contributions to a qualified plan and simplified employee pensions of all corporations, partnerships, and sole proprietorships in which the individual has more than 50 percent control.²⁸ Thus, contributions to such plans may have to be aggregated with contributions to a SEP or SARSEP for purposes of the 100 percent and \$45,000 (for 2007) limit discussed above, as well as the \$15,500 and \$20,500 elective deferral limits.

Example. Carlos has a 51 percent interest in a small business that established a SEP for 2007. Carlos is also a participant in a 403(b) plan maintained by a tax-exempt entity. Carlos must aggregate contributions to both plans for purposes of the 100 percent/\$45,000 limit under IRC Section 415. If Carlos had 15 or more years of service with a qualifying organization an additional amount could be contributed.²⁹

6. *The excess SEP contributions limit.* This applies to contributions that fail the 125 percent nondiscrimination test of IRC Section 408(k)(6)(iii), which would affect only HCEs.
7. *Disallowed deferrals.* This applies to deferrals failing the 50 percent participation rate requirement of IRC Section 408(k)(6)(A)(ii).
8. *The \$5,000 (for 2007) catch-up contribution limit.* Elective deferrals that exceed any applicable limit are treated as catch-up contributions. The catch-up contribution limit is \$5,000 (for 2006 and 2007) and available for participants age 50 or older.³⁰

Note. Generally, the applicable dollar amount for any limit (except the \$45,000/\$50,000 elective contribution limit) is computed by reference to the limit in effect for the calendar year in which the plan year began. Special rules apply to catch up contributions (discussed later). See Appendix D.

Except for nondeductible contributions (see item 2), all excesses are includable in gross income at different times and in different manners. Some excesses require notification (items 5, 6, and 7), others must satisfy IRS reporting requirements. Different types of excesses are treated in different manners. For example, items 6, 7, and 8 do not apply to the extent the 25 percent exclusion limit (item 1) is exceeded.

²⁷ IRC Section 415(c)(1)(A).

²⁸ IRC Sections 415(a)(2), 415(h); see also Treas. Reg. §1.415-6(e).

²⁹ See IRC Section 402(g)(7). A participant's 403(b) employer is not considered to maintain the tax-sheltered annuity contract (or custodial account) under IRC Section 403(b) unless the participant has more than 50 percent control in another employer. Thus, in many cases, contributions under a SEP and a non-ERISA 403(b) arrangement (elective deferral plan only) need not be aggregated for purposes of the 100 percent / \$45,000 limit under IRC Section 415, nor for purposes of the prior limits under IRC Section 415(e) regarding defined benefit plans and SEPs. See IRC Section 415(k)(4); Treas. Reg. §§1.415-7(h)(1)(i), 1.415-7(h)(2); Prop. Treas. Reg. §1.415(f)-1(g); Ltr. Rul. 8833047.

³⁰ IRC Sections 402(h)(2), 414(v)(3)(A); Treas. Reg. Section 1.414(v)-1(c)(1).

Note. In taxable years after 2001, employers are no longer required to establish a SEP in combination with a pension plan (such as a 10 percent money-purchase pension plan) to qualify for the 25 percent overall employer deduction limit.

Note. For taxable years beginning after 2001, EGTRRA allows for contributions to domestic and similar workers to continue to be made on a nondeductible basis, and the 10 percent excise tax on nondeductible contributions will not apply to a SIMPLE 401(k) or a SIMPLE IRA because such contributions are not a trade or business expense.³¹ Unfortunately, similar provisions were not made for SEP or SARSEP that cover only a domestic or household worker. Thus, nondeductible SEP contributions may be subject to the 10 percent excise tax.

Nondiscriminatory Coverage

In general, a SEP is considered discriminatory unless contributions bear a uniform relationship to the compensation of the employees covered.³² In applying this rule, only the first \$225,000 in compensation may be considered for a plan year beginning in 2007 (\$220,000 for 2006). That compensation limit amount is periodically adjusted for inflation.

Nondiscriminatory Contributions

Contributions to a SEP must not discriminate in favor of any HCE.³³ For 2007, the term *highly compensated employee* (or *HCE*) means either of the following:

- An individual who was a 5 percent owner at any time during the current or preceding year, or
- An individual who had compensation from the employer exceeding \$100,000 for the preceding year. (The employer may elect for a year to limit this to a person who was in the top-paid group of employees for that year.)³⁴

The rule requiring the company's highest paid officer to be treated as an HCE was repealed for plan years beginning after 1996.

No Maximum Age Restrictions

There are no maximum age restrictions in a SEP. Eligible employees may participate in a SEP plan regardless of their age. Unlike contributions to a traditional IRA, SEP contributions may be made by the employer to the IRA of an eligible employee after he or she reaches age 70½. Even though SEP contributions may continue beyond age 70½, required minimum distributions (RMDs) must be made from the SEP IRA on a timely basis.

³¹ IRC Section 4972(c)(6).

³² IRC Section 408(k)(3)(C).

³³ IRC Section 408(k)(3).

³⁴ IRC Section 414(q).

Salary-Reduction Contribution

A SEP may include a salary-reduction feature, under which employees can choose to have contributions made from their pay to their IRAs, established under the SEP.³⁵ SARSEP were replaced by SIMPLE plans for years after 1996. Accordingly, no new salary-reduction SEP may be established, but existing ones are grandfathered under the new law. Elective deferrals are permitted only if the following conditions are met:

1. At least 50 percent of the employees eligible to participate choose to make elective deferrals for the plan year.³⁶
2. The employer had no more than 25 eligible employees (or employees who would have been required to be eligible if a SEP had been maintained) at any time during the preceding plan year.³⁷
3. The amount deferred each year by each eligible HCE, as a percentage of compensation, is no more than 125 percent of the average deferral percentage for all other eligible employees, determined separately.³⁸

Compensation in excess of \$225,000 for 2007 is not considered in figuring an employee's deferral percentage.³⁹

NHCE Compensation Deferred Amount Percentage Deferred

Under the 125 percent rule (also known as the ADP test), the percentage of total compensation (expressed to 2 decimal places) elected to be deferred by each eligible HCE for the current year, excluding catch-up contributions, must not exceed the average of the individual deferral percentages, computed separately and without regard to catch-up contributions, for all eligible NHCEs multiplied by 1.25.⁴⁰

Example. Under a grandfathered prototype SARSEP that uses gross compensation (without reduction for elective contributions) for deferral percentage testing and allocation purposes, a company's nonhighly compensated employees (NHCEs) elect to reduce their compensation and contribute the noted percentages of their compensation for 2007, as follows:

NHCE	Compensation	Deferred Amount	Percentage Deferred
Alice	\$10,000	\$800	8%
Bruce	\$ 9,000	\$360	4%
Carol	\$ 8,000	\$320	4%
Drew	\$ 7,000	\$ 0	0%

³⁵ IRC Section 408(k)(6).

³⁶ IRC Section 408(k)(6)(A)(ii).

³⁷ IRC Section 408(k)(6)(B).

³⁸ IRC Section 408(k)(6)(A)(iii).

³⁹ IRC Section 408(k)(6)(B)(ii).

⁴⁰ IRC Sections 408(k)(6)(A)(iii), 414(v)(3).

The correct method for computing the percentage of compensation that each eligible HCE may elect to defer is to sum the NHCEs' individual percentages (that is, determined separately):

$$\text{Average NHCE Deferral: } (8\% + 4\% + 4\% + 0\% = 16\%) / 4 = 4\%$$

This result, 4 percent, multiplied by 1.25, gives 5 percent, which may be deferred by each eligible HCE up to \$15,500, plus catch-up contributions for the 2007 plan year. On the other hand, it is incorrect to compute the total dollars deferred as a percentage of compensation. Such a computation would be

$$(\$800 + \$360 + \$320 + \$0) / (\$10,000 + \$9,000 + \$8,000 + \$7,000) = 4.35\%$$

This incorrect result, 4.35 percent, multiplied by 1.25 percent gives 5.44 percent.

Caution: *Except as otherwise indicated, the examples in this chapter assume a prototype SARSEP is used which defines compensation for ADP testing purposes as gross compensation (before reduction for elective deferrals). In a model SARSEP (Form 5305A-SEP), the term "compensation" generally excludes elective contributions that are made by the participant to the plan. Under the model document, the ADP percentage for an employee that deferred \$500 from gross wages of \$10,000 would be 5.26 percent (\$500/\$9,500). If a model document were used in the example above, the average of the NHCEs' deferral would be 4.26 percent $((8.7 + 4.17 + 4.17 + 0) / 4)$ rather than 4. An HCE employee could defer 5.32 percent $(4.26 \text{ percent} \times 1.25)$ under the model plan; however, if any nonelective employer SEP contributions are made, plan provisions would generally require that they be allocated based on reduced compensation (that is, excluding the elective deferrals). It should be noted that the 25 percent exclusion limit is always based on reduced compensation.⁴¹*

Example. The facts are the same as those in the preceding example, except that one HCE is over age 50 on December 31, 2007. That HCE may defer 5 percent of total compensation, up to \$15,500, plus a catch-up contribution of up to \$5,000.

Note. The percentage that may be deferred by any one eligible HCE is not dependent (as generally is the case in a traditional 401(k) plan) on percentages or amounts that other HCEs elect to defer.

Example. Marlin Corporation maintains a SARSEP for its employees using Form 5305A-SEP. Its three NHCEs elect to defer 2 percent, 3 percent, and 4 percent, respectively, of their compensation. The only other eligible employee is the owner, Vicki, and she contributes her allowed maximum of 3.75 percent, computed by taking the average of the deferral rates of each eligible NHCE (separately determined for each employee) and multiplying it by 1.25. Because Vicki is a key employee and a plan participant, the SARSEP arrangement is deemed top heavy and Marlin must contribute 3 percent (that is, the lesser of 3 percent or 3.75 percent) to each non-key employee.

Note. Elective contributions must be reduced if the 25 percent of includable compensation limit is exceeded. The amount of elective deferrals in excess of the 25 percent exclusion limit may possibly be treated as a catch-up contribution.

⁴¹ See also Publication 4336, Salary Reduction Plans for Small Businesses, that uses unreduced compensation for the ADP denominator without distinguishing between plan types (i.e., model or prototype plan document). Publication 4336 is available at www.irs.gov/pub/irs-pdf/p4336.pdf.

Elective deferrals for nonkey employees may not be used to satisfy the minimum contribution top-heavy rules.⁴²

The salary reduction contribution limit of \$15,500 and catch-up contribution limit of \$5,000 (the 2007 limits) are indexed for cost-of-living adjustments (COLAs). The limit applies to (on the employer and individual level) the aggregate of salary-reduction contributions made to all plans permitting such contributions, including, for example, 401(k) plans.

Example. Moe, age 30, who has moonlighting income, establishes a SEP program for 2007. Moe also makes an \$8,000 salary-reduction contribution to an unrelated employer's 401(k) plan for 2007. The most Moe may contribute to the SARSEP is \$7,500 (\$15,500 annual limit reduced by the \$8,000 elective contribution). If Moe was age 50 or older, any catch-up contributions would be limited to \$5,000 in the aggregate.

Catch-Up Contributions

An individual is eligible to make a catch-up contribution to an SARSEP if the individual is treated as attaining age 50 at any time during the plan year. A calendar-year taxpayer who attains age 50 by the end of the employees' taxable year (December 31) is treated as having attained age 50 on January 1 of that year.

Example. Lee will turn age 50 on December 31, 2007 and is a participant in her employer's SARSEP. The plan year ends on June 30, 2007. Lee is eligible to make catch-up contributions for the plan year ending in 2007 because she attained age 50 in the calendar year in which the plan year ended.

Elective deferrals in excess of an applicable limit are treated as catch-up contributions to the extent that elective deferrals do not exceed the catch-up contribution limit for the tax year reduced by elective deferrals previously treated as catch-up contributions for the tax year. For 2007, the catch-up contribution limit for an SARSEP is \$5,000 (\$2,500 in the case of a SIMPLE IRA).⁴³ Unless an individual also participates in an eligible governmental 457 plan, he or she is entitled to exclude from income only catch-up amounts that do not exceed \$5,000 in the aggregate for 2007.⁴⁴

The amount of elective deferrals in excess of an applicable limit is generally determined as of the end of a plan year by comparing the total elective deferrals for the plan year with the applicable limit for the plan year. For a limit that is determined on the basis of a year other than a plan year (such as the calendar-year limit on elective deferrals under IRC Section 401(a)(30)), the determination of whether elective deferrals are in excess of the applicable limit is made on the basis of such other year.⁴⁵

Note. Even though plan years may overlap, the elective deferral limits are determined on a calendar year basis. Thus, a SARSEP maintained on a basis other than the calendar year may have a difficult time computing applicable limits and the periods for which they apply.

Catch-up contributions are determined by reference to statutory limits, employer-provided limits, and the actual deferral percentage (ADP) limit, all of which are discussed in more detail in the following:

⁴² IRC Section 408(k)(3).

⁴³ IRC Section 414(v)(2)(B).

⁴⁴ Treas. Reg. Section 1.414-1(g)(2).

⁴⁵ Treas. Reg. Section 1.414(v)-1(c)(3).

- **Statutory limits.** The Code includes statutory limits that pertain to elective deferrals or annual additions permitted to be made under a SARSEP without regard to IRC Section 414(v). Statutory limits include the requirement under IRC Section 401(a)(30) that the plan limit all elective deferrals within a calendar year under the plan and other plans (or contracts) maintained by members of a controlled group to the amount permitted under IRC Section 402(g) regarding elective contributions.⁴⁶ The 25 percent of includable compensation exclusion limit is also a statutory limit.
- **Employer-provided limit.** An *employer-provided limit* is the limit placed on employees' elective deferrals under the terms of the plan. SARSEP do not generally contain plan limits on elective deferrals. Admittedly, some employers cap elective deferrals when they intend to make a top-heavy or other nonelective contribution to employees' accounts.
- **The ADP limit.** For purposes of the 125 percent deferral test in a SARSEP, regulations provide that any elective deferral for the plan year that is treated as a catch-up contribution, because it is in excess of a statutory limit or an employer-provided limit, be disregarded for purposes of calculating the participant's actual deferral ratio. That is, catch-up contributions are subtracted from the participant's elective deferrals for the plan year prior to determining the participant's actual deferral ratio. This subtraction applies without regard to whether the catch-up eligible participant is an HCE or an NHCE.⁴⁷

Example. Leonard is an HCE and a catch-up-eligible participant under a SARSEP with a plan year ending October 31, 2007. For the plan year ending in 2007 he made elective deferrals of which \$5,100 was treated as catch-up contributions. If Leonard makes elective contributions for the period starting on November 1, 2007 through December 31, 2007, all elective contributions would be treated as catch-up contributions because he has already made the maximum normal elective contribution (which is determined on a calendar year basis). Any deferrals of more than \$400 (\$5,500 - \$5,100) during that 3 month period would be treated as excess contributions.

Catch-Up Rules

Catch-up contributions are not subject to otherwise applicable limits under a SEP. Thus, an elective deferral that is treated as a catch-up contribution is not subject to otherwise applicable limits under the SEP, and the plan would not be treated as failing otherwise applicable nondiscrimination requirements because of the catch-up contributions. Catch-up contributions would not be taken into account in applying the limits of certain sections of the IRC (for example, IRC Sections 401(a)(30), 402(h), 404(h), 408(k), 408(p), 415, and 457) to other contributions or benefits under the plan offering catch-up contributions or under any other plan of the employer.⁴⁸

Caution: *Because an amount treated as a catch-up contribution is not taken into account in calculating the ADP rate, the ADP rate may have to be recalculated if unanticipated catch-up amounts are determined to exist for any participating NHCE.*

Example. Jenny, age 60, is a participant in her employer SARSEP. From her wages of \$20,000, Jenny makes \$4,500 of elective contributions for the plan year. Jenny's maximum normal contribution cannot

⁴⁶ IRC Section 408(k)(6)(A)(iv).

⁴⁷ Treas. Reg. Section 1.414(v)-1(d)(2).

⁴⁸ Treas. Reg. Section 1.414(v)-1(d).

exceed 25 percent of includible compensation (the participant exclusion limit) of \$4,000.⁴⁹ Although a statutory limit was exceeded by \$500, that amount may be treated as a catch up contribution. If the employer calculated the ADP rate applicable to HCEs using \$4,500, it will have to recompute the allowable ADP rate using \$4,000.

Example. Same facts as in the preceding example, except Jenny's employer contributes 25 percent of compensation (the maximum allowable employer contribution) to each employee's SARSEP IRA. None of the elective contributions that were made for the year can be treated as normal elective contributions under the plan. Nonetheless, Jenny's elective contributions (\$4,500) will be treated as catch-up contributions up to the limit maximum catch-up limit of \$5,000 for 2007.

Special timing and notification rules apply to excess elective contributions. In addition to contributions in excess of the 100 percent (up to \$45,000/\$50,000, as indexed and adjusted) overall limit on total contributions to any one participant's account, the participant's exclusion limit of 25 percent of compensation, and the employer's 25 percent of aggregate compensation deduction limit, three other kinds of excess contributions might occur in a SEP arrangement that allows for elective deferrals:

1. Excess deferrals (deferrals exceeding the taxpayer's deferral limit under IRC Section 402(g), \$15,500 for 2007;
2. Excess SEP contributions (contributions failing the 125 percent nondiscrimination test),⁵⁰ which would affect only HCEs; and
3. Disallowed deferrals (deferrals failing the 50 percent participation rate requirement).⁵¹

Top-Heavy Considerations

Catch-up contributions with respect to the current plan year are not taken into account for purposes of IRC Section 416 regarding top-heavy contribution requirements. However, catch-up contributions for prior years are taken into account for purposes of IRC Section 416. Thus, catch-up contributions for prior years are included in the account balances that may be used in determining whether a plan is top heavy under IRC Section 416(g).⁵²

IRC Section 415 Limit Considerations

Catch-up elective contributions are also not taken into account in determining whether the 100 percent of compensation limit has been exceeded. Other limits, such as the 25 percent of includable compensation exclusion limit, are always lower than the 100 percent of compensation limit.⁵³

Catch-Up Contributions Deductibility

All elective contributions (including catch-up elective contributions) are deductible by the employer.⁵⁴

⁴⁹ The 25 percent participant exclusion limit is equal to 20 percent of unreduced (pre-plan) compensation assuming nonelective contributions are not made (or required to be made) by the employer. $\$20,000 \text{ divided by } .25 \text{ over } 1.25 \text{ equals the } \$4,000 \text{ normal elective limit computed in the example.}$

⁵⁰ IRC Section 408(k)(6)(A)(iii).

⁵¹ IRC Section 408(k)(6)(A)(ii).

⁵² Treas. Reg. Section 1.414(v)-1(d)(2)(iv).

⁵³ IRC Section 414(v)(3)(A)(i).

⁵⁴ IRC Section 404(n).

Salary-Reduction Limit

An employee may contribute as much as \$15,500 for 2007 by means of a salary-reduction agreement. If an individual participates in a SARSEP and attains age 50 by the end of the calendar year, he or she may make additional elective deferrals up to an applicable dollar limit. That catch-up amount is in addition to the normal deferral limit for the applicable year. The maximum amount of the catch-up contributions is the lesser of the participant's compensation for the year or the applicable dollar amount.⁵⁵ The applicable dollar amounts and catch-up limits for years beginning after 2004 are as follows:⁵⁶

Year	Increased Deferral Limit	Catch-Up Limit
2005	\$14,000	\$4,000
2006	\$15,000	\$5,000
2007	\$15,500	\$5,000
2008	Indexed in \$500 increments	Indexed in \$500 increments*

Example. Herb, a calendar-year taxpayer, attains age 50 on November 3, 2007. Herb is a participant in a SARSEP with a plan year ending on June 30, 2007. He is eligible to make a catch-up contribution for 2007 because he is treated as having attained age 50 on January 1, 2007, which is within the plan year starting July 1, 2006.

Maximum Compensation Limits

EGTRRA increased the maximum compensation that can be considered on behalf of any participant in a SEP from \$150,000 (actually \$170,000 for 2001 because of COLAs) to \$200,000 for plan years beginning after 2001. The \$200,000 limit is to be increased for COLAs in increments of \$5,000. For 2007, the limit is \$225,000. Plan documents determine the actual definition of compensation that is to be used by the adopting employer for various purposes under the plan. SEP plans do not, however, define compensation for employer deduction or participant exclusion purposes.

After 2001, the definition of compensation for SEP (and SIMPLE) includes an individual's net earnings that would be subject to taxes under SECA but for the fact that the individual is covered by a religious exemption.⁵⁷ In addition, after 2001, the compensation received by a nonresident alien who is a regular member of a crew on a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States is not considered U.S.-source income for purposes of a SEP (or any qualified retirement plan or SIMPLE IRA).⁵⁸

⁵⁵ IRC Section 414(v); Treas. Reg. Section 1.414(v).

⁵⁶ IRC Section 402(g)(1). The \$15,500 elective deferral limit is to be increased for COLAs in increments of \$500 after 2006. IRC Section 402(g)(5).

⁵⁷ IRC Sections 401(a)(17), 404(k), 408(l).

⁵⁸ IRC Section 861(a)(3).

Integration With Social Security

If a SEP is integrated with Social Security, the contribution percentage made with respect to compensation above a certain amount (the integration level) is higher than the percentage contributed on compensation below that point. The integration of SEP contributions with Social Security is more fully discussed in Chapter 7.

More Than One Plan

If the employer makes contributions to more than one SEP or to a qualified plan, a special limit called the *annual addition limit* applies. For 2007, that limit is equal to the *lesser of*:

- 100 percent of preplan compensation for the limitation year (that is, without reduction for elective contributions and salary-reduction contributions to cafeteria plans)
- \$45,000 (including elective contributions (maximum \$15,500) but not catch-up (maximum \$5,000) contributions for 2007)

Exclusion of Contributions by Employee

Generally, a SEP/SARSEP contribution is not includable in an employee's gross income nor treated as wages to the extent that the contributions do not exceed the lesser of (1) 25 percent of includable taxable compensation for the plan year without regard to the contributions or (2) \$45,000.⁵⁹ Catch-up contributions are separately excludable from a participant's gross income up to \$5,000, the limit on catch-up contributions for 2007.⁶⁰

Example. Joan participates in her employer's elective SEP plan which is maintained on a calendar year basis. She has Form W-2, Wage and Tax Statement, compensation of \$9,500 for 2007 after making a \$500 elective contribution. The 25 percent exclusion limit would be based on \$9,500. Thus, the sum of Joan's employer's contributions, including elective deferrals, cannot exceed \$2,375 ($\$9,500 \times .25$). Although the employer's deduction limit is higher, specifically, \$3,000 [$(\$10,000 \times .25) + \500], amounts allocated to Joan in excess of \$2,375 would be includable in her gross income.

Example. Joe, age 50, participates in his employer's SARSEP which is maintained on a calendar year basis. Joe's preplan compensation is \$100,000. He contributes \$16,000 of that amount to his SEP IRA of which \$500 is treated as an elective catch-up contribution. Joe's exclusion limit can be computed as follows:

$$\$100,000 - \$15,500 = \$84,500$$

$$\$84,500 \times .25 = \$21,125$$

The sum of \$21,125 and \$500 is \$21,625, the most that may be excluded from Joe's income when combined with any nonelective employer contributions.

⁵⁹ IRC Section 402(h).

⁶⁰ IRC Section 414(v).

The maximum employer's contribution that does not result in a reduction of the normal elective deferral limit can be determined as follows:

Preplan compensation	\$100,000
Less elective contributions	–15,500
Exclusion compensation (IRC Section 402(h))	\$ 84,500
Exclusion percentage × .25	× .25
Maximum excludable contribution	\$21,125
Less total elective contribution	\$15,500
Maximum excludable employer contribution	\$ 5,625

Contribution Due Dates

SEP are permitted to be based on an employer's fiscal tax year or based on the calendar year. A business may deduct contributions to a SEP on its business tax return if the contribution to the SEP IRA is made *after* the business tax return is filed but *before* the due date of the return.⁶¹

To be granted an extension of time to make a SEP contribution, a corporation must file Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns, by the regular due date of its Form 1120, U.S. Corporation Income Tax Return, or 1120S, U.S. Income Tax Return for an S Corporation. The automatic extension is six months. The balance due on line 6 must be paid and the extension filed by the due date for the return for which the extension applies. Special rules apply to foreign corporations. An extension does not operate to extend the time for payment of any tax due on the return being extended.⁶²

Note. If an entity is tax exempt, it has until the due date of its Form 990 (generally, the 15th day of the 5th month following the close of its accounting period) to establish a SEP (but not a SARSEP) arrangement.

If the business is not taxed as a corporation, all owners should have their personal income tax returns extended to the date the contribution is to be made, or later. A partnership must file Form 7004, Application for Automatic 6-Month Extension of Time To File Certain Business Income Tax, Information, and Other Returns, for a Partnership, REMIC, or Certain Trusts, by the regular due date of its Form 1065, U.S. Partnership Return of Income. The automatic partnership extension is six months. All partners should have their personal income tax returns extended to the date that the partnership's tax return is due. The automatic extension does not operate to extend the time for payment of any tax due on the return being extended.⁶³

⁶¹ Rev. Rul. 84-18 (1984-1 C.B. 88). See also Ltr. Ruls. 8536085 (Jun. 14, 1985), 8628047 (Apr. 15, 1986), and 8611090 (Dec. 20, 1985) regarding post office cancellation date for IRA contributions and the Taxpayer's Bill of Rights.

⁶² Treas. Reg. §1.6081-5(a)(1); Treas. Reg. §1.6081-5(a)(5).

⁶³ Treas. Reg. §1.6081-5(a)(1); Treas. Reg. §1.6081-5(a)(5).

Deduction Timing

For the purpose of claiming a deduction for its contribution, an employer may establish its plan on the basis of its business taxable year or on the basis of the calendar year. The plan must be based on the calendar year when an employer is using the IRS model Form 5305-SEP or Form 5305A-SEP to establish its SEP or SARSEP. Most prototype SEP allow for an employer to choose between maintaining its plan on the basis of its business taxable year or maintaining it on the basis of the calendar year.

Special rules apply to the timing of the deductibility of an employer's contribution when a SEP is not maintained on the basis of its business taxable year (or if the plan is amended to change the plan year⁶⁴). Within the prescribed limits, all SEP and SARSEP contributions are deductible by the employer if paid by the due date (including extensions) of the business tax return and made on account of that taxable year. Nonetheless, SARSEP contributions (which are plan assets) must be forwarded sooner to comply with Department of Labor (DOL) rules. (See Chapter 20, "Deadlines for Depositing Employer Contributions and Loan Repayments.")

The prorating of SEP contributions for a plan year between two taxable years is not permitted for deduction purposes. Contributions are deductible by the employer in accordance with the following rules:⁶⁵

1. In the case of a SEP maintained by a *calendar-year business* on a *calendar-year basis*, contributions are deductible for such *calendar year*.
2. Contributions made to SEP maintained on the basis of the *employer's taxable year* are deductible for such *taxable year*.
3. When a *fiscal-year business* maintains a SEP on a *calendar-year basis*, contributions are deductible for the fiscal taxable year that includes December 31.

SEP and Traditional IRA

Nothing in the law prohibits an employee from also using his or her IRA established under a SEP as a personal IRA. A particular financial institution may establish individual restrictions. An employee with compensation of at least \$4,000 (\$5,000 with catch-up contributions for 2007 and 2008) may generally contribute an additional \$4,000 (\$5,000 with catch-up contributions) to his or her SEP IRA for 2007 and 2008, although the contribution may not be deductible because of the employee's participation in the SEP.

Withdrawals

A SEP may not prohibit employees from withdrawing amounts from their IRAs established or funded under the program (but see below).⁶⁶ Similarly, employer contributions to a SEP may not be conditioned on employees' agreeing not to withdraw those amounts.⁶⁷

⁶⁴ Special plan provisions are required to change SEP plan years. In general, the employee is to be treated as a participant in *both* the short plan year and the new plan year if the employee was eligible to participate in either of those periods.

⁶⁵ IRC Section 404(h).

⁶⁶ IRC Section 408(k)(4).

⁶⁷ IRC Section 408(a)(3), 408(c).

Restricted Funds

Elective contributions made to a SARSEP may not be withdrawn or transferred to another IRA or SEP IRA until the earlier of:

1. The time a determination is made by the employer that the special 125 percent nondiscrimination test has been satisfied, or
2. March 15 following the close of the plan year.

Until such determination is made, any transfer or distribution from a SEP of restricted funds (salary-reduction contributions and income attributable to such contributions) is subject to tax and may be subject to the 10 percent premature distribution penalty regardless of whether an exception to the tax would otherwise apply.⁶⁸ Excess elective deferrals (amounts in excess of \$15,500 plus catch-up contributions for 2007) may be withdrawn before this time; however, they may not be rolled over or transferred to another IRA.

Note. It is not clear whether the restriction applies to all employees or just to HCEs. Any distribution, transfer, or rollover of the restricted funds before employer certification or before March 15 following the end of the plan year may be treated as an *other than* excess contribution, permitted to be withdrawn without penalty. The tax, if any, is reported on Form 5329.⁶⁹

Excess Contributions

The general rules that apply to excess contributions in traditional IRAs apply to participants in SEP IRAs. In general, an excess contribution made to a participant's SEP IRA may be corrected without the individual's having to pay a 6 percent penalty tax provided the amount is removed (adjusted for gain or loss) before the due date of the individual's federal income tax return (including extensions), and no deduction is taken for the contribution. If a taxpayer's return has been timely filed without withdrawing the excess contribution, the amount may still be withdrawn without penalty no later than six months after the due date of the tax return, *excluding* extensions. If the excess is withdrawn within this period, the participant must file an amended return with "Filed pursuant to Section 301.9100-2" written at the top of the amended tax return, report any related earnings on the amended return, and include an explanation of the withdrawal. Any other necessary changes should be made on the return (for example, if the contribution was reported as an excess contribution on the original return, an amended Form 5329 should be included, reflecting the fact that the withdrawn excess contributions are no longer treated as having been contributed).⁷⁰

Top-Heavy Rules

The top-heavy rules for qualified employer retirement plans apply also to SEP. Instead of using aggregate account balances to determine whether an individually designed SEP plan is top heavy (as required with a qualified plan), an employer may elect to use annual contributions (presumably for all years). This means, for

⁶⁸ IRC Section 408(d)(7)(A).

⁶⁹ Form 5329, Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs.

⁷⁰ Treas. Reg. Section 301.9100-2; Instructions for Form 5329, "Specific Instructions," pt. III (2003).

example, that if key employees' IRAs receive more than 60 percent of the aggregate employer contributions allocated to employees for all plan years, the employer must contribute to the IRAs of nonkey employees the *lesser of either*:

1. 3 percent of plan year compensation, or
2. The highest percentage of plan year compensation contributed to any key employee's IRA.

Prototype and model plans use the annual contribution method to determine whether the plan is top heavy.

Caution: *The IRS model SEP agreement, Form 5305A-SEP, is automatically deemed top heavy if any key employee makes an elective contribution. Because SEP generally requires uniform contributions, these rules are important only for integrated SEP and SARSEP that are top heavy or (as is generally the case with the IRS model plan) deemed top heavy.*

Key Employee

The term *key employee* was modified by EGTRRA for 2002. For plan years beginning after 2001, an employee is considered a key employee if, during the plan year, he or she was one of the following:

- An officer with compensation in excess of \$145,000 (as adjusted for COLAs in \$5,000 increments) for 2007
- An owner of more than 5 percent, or
- A more than 1 percent owner with compensation in excess of \$150,000

EGTRRA eliminated the four-year look-back and the top 10 owner rules. The family ownership attribution rules under IRC Section 318,⁷¹ however, apply in determining whether an individual is a more than 5 percent owner of the employer for purposes of these rules.⁷² For purposes of determining a plan's top-heavy status, the five-year look-back period applicable to distributions was one year, except for in-service distributions. Also, if an employee has not performed services for the employer during the one-year period ending on the date the top-heavy determination is being made, that employee's account balance is not taken into account for determining top-heavy status.⁷³

Caution: *There is no age-21 rule or exception under the IRC Section 318 attribution rules. Legally adopted children are treated as blood relatives.⁷⁴*

IRC Section 318 Attribution

An individual is deemed to own stock (or other ownership interests) held by his or her spouse unless they are divorced or legally separated under a decree of separate maintenance. Unlike the controlled group rules,

⁷¹ See, S. Derrin Watson, "Who's The Employer," a guide to employee and aggregation issues affecting qualified plans and SEPs, Qs 14:1-14:17 (4th Ed, 2005) at <http://www.employerbook.com/WTE4/>.

⁷² IRC Sections 408(k)(6)(G); 416(i)(1)(A) and (B).

⁷³ IRC Sections 416(i).

⁷⁴ IRC Section 318(a)(1)(B).

there apparently is attribution between spouses even if there is an interlocutory decree of divorce, and even if the nonowning spouse is not involved in the business.⁷⁵

An individual is also deemed to own stock (or other ownership interests) held by his or her parents, children, and grandchildren.⁷⁶ Notice that there is attribution from grandchild to grandparent but not from grandparent to grandchild. There is no age-21 rule limiting the attribution of stock between parent and child. Adopted children are treated as blood relatives.⁷⁷ There is no double attribution under the family rules, although stock deemed to be owned under one of the other rules (such as attribution from trusts or options) can then be deemed to be owned by a family member.

Family Attribution

Example. The Robinson family members consist of Dad and Mom, a married couple, and their children (Brother and Sister), and Sister's daughter, Grandkid. Brother was adopted. Their ownership of Xavier Corporation is as shown in the following table:⁷⁸

Family Member	Shares
Dad	500
Mom	400
Sister	300
Brother	200
Grandkid	100

- Mom and Dad are each deemed to own all 1,500 shares.
- Sister is deemed to own 1,300 shares, all but Brother's.
- Brother is deemed to own 1,100 shares, excepting Sister's and Grandkid's.
- Grandkid is deemed to own 400 shares, just her own and her mother's.

Key Employee Family Attribution

Example. Each of the following owns 1 percent of Trout Corporation, namely, Sam, Sam's wife, Sam's mother, Sam's grandmother, Sam's son, and Sam's granddaughter (the daughter of Sam's son). Sam is deemed to own the stock of all those individuals other than Sam's grandmother. That gives Sam exactly 5 percent. Since a 5 percent owner is one who owns more than 5 percent of a company, Sam is not a 5 percent owner. Sam and each of his five family members is a 1 percent owner, however, since each is deemed to own more than 1 percent.

No Double Family Attribution

Example. Son, Daughter, and Mother each own 2.5 percent of The Chrysanthemum Corporation. Son and Daughter are each deemed to own 5 percent, while Mother is deemed to own 7.5 percent. Son's stock cannot

⁷⁵ IRC Section 318(a)(1)(A)(i).

⁷⁶ IRC Section 318(a)(1)(A)(ii).

⁷⁷ IRC Section 318(a)(1)(B).

⁷⁸ See, S. Derrin Watson, "Who's The Employer," Q 14:7 (4th Ed, 2005) at <http://www.employerbook.com>. Examples used with permission.

be attributed to Daughter through Mother. Son and Daughter are not 5 percent owners (again that requires more than 5 percent), while Mother is a 5 percent owner.

Option Precedence

Example. The facts are the same as in the preceding example, except Mother has an option to buy Son's stock. So, Mother is deemed to own Son's stock because of option attribution, not because of the family rules, which means it can be attributed from her to Daughter. Accordingly, both Mother and Daughter are deemed to own 7.5 percent of Chrysanthemum. Son is still deemed to own 5 percent.

Stepchildren

Example. Mabel owns 4 percent of Second Chance, Inc., and her stepson, Roy, owns 2 percent. On these facts, neither is a 5 percent owner. There is no attribution between stepchild and stepparent. That would require double family attribution through Roy's father (Mabel's husband).

Stock Attribution, Not Compensation Attribution

Example. Dad owns 3 percent of Nepotism, Inc. His salary from the company is \$160,000 per year and hence he is an HCE and a key employee. Daughter does not own any stock in the company, but does receive a salary of \$40,000 per year. Daughter is not an HCE or a key employee. She is deemed to own Dad's stock, but 3 percent ownership will not make her an HCE. His compensation is not attributed to her, and her compensation is insufficient to make her an HCE or a key employee.

ERISA Considerations

SEPs are pension plans generally subject to the requirements of ERISA, including its reporting and disclosure obligations. Simple annual reporting requirements apply if the employer has adopted the IRS model SEP without modification. In that case, the employer need only have complied as follows:

1. Provide employees with copies of the completed Form 5305-SEP.
2. Notify each employee in writing of the amount of employer contribution for the year.
3. If the employer selected or otherwise influenced an employee's selection of a particular IRA that restricts the withdrawal of funds, provide a written explanation of the restrictions and inform the employee of the availability of IRAs that do not restrict withdrawal.

An employer must also inform its employees of the SEP's adoption and its terms, including a description of participation requirements and the benefit allocation formula. Such information is to be provided within a reasonable time after an employee becomes employed (or after the SEP is adopted, if later). The instructions to IRS Form 5305-SEP indicate this requirement is satisfied if the employer adopts the IRS model SEP and gives the employee a photocopy of the completed Form 5305-SEP. Similar requirements apply to a prototype SEP. The sponsor of a prototype SEP will generally provide a "fill-in-the-blanks" disclosure statement designed to satisfy ERISA's annual reporting requirements. An employer must also provide each employee annually with a statement showing the amount contributed to the IRA on the employee's behalf. This requirement is satisfied if the information is recorded on an employee's Form W-2. If the employer cannot locate an employee, the IRS may require that the employer file reports with the IRS for the employee.

Note. ERISA prohibits any person from using fraud, force or violence (or threatening force or violence) to restrain, coerce, or intimidate any plan participant or beneficiary in order to interfere with or prevent the exercise of their rights under the plan. Willful violation of this prohibition is a criminal offense subject to a \$10,000 fine or imprisonment of up to one year, or both. The Pension Protection Act (PPA) increases the penalties for willful acts of coercive interference with participants' rights under an ERISA plan. The amount of the fine is increased to \$100,000, and the maximum term of imprisonment is increased to 10 years.⁷⁹

Form Filing

Employers maintaining SEP or SARSEP arrangements generally do not have to file any of the Form 5500 series annual return/reports for employee benefit plans when they conform to the alternate methods of compliance. Generally, under Title I of ERISA, relief from the annual reporting requirements is not available to an employer who selects, recommends, or in any other way influences employees to choose a particular IRA or type of IRA into which contributions under the SEP will be made *if* those IRAs are subject to restrictions that prohibit the withdrawal of funds for any period (other than restrictions imposed by the Code that apply to all IRAs). Under current law, the Secretary of the Treasury has the authority to require an employer who makes contributions to a SEP to provide simplified reports with respect to such contributions. Such reports could appropriately include information about compliance with the requirements that apply to SEP, including the contribution limits.⁸⁰ The IRS is concerned that many employers are not covering all of their eligible employees. It is likely that simplified reports will eventually be mandated for SEP plans.

Bonding

In most cases, an employer that handles funds or other property that belongs to an ERISA plan (including a SEP or SIMPLE) is required to be bonded. The basic standard is determined by the possibility of risk or loss in each situation; thus, it is based upon the facts and circumstances in each situation. The amount of such bond, which is determined at the beginning of each year, generally cannot be less than 10 percent of the amount of funds handled. The minimum bond is \$1,000. However, contributions made by withholding from an employee's salary are not considered funds or other property of a SIMPLE (or SEP) for purposes of the bonding provisions so long as they are retained and not segregated in any way from the general assets of the withholding employer. Because employer contributions are made into IRAs established by each employee (which are outside the control of an employer once made), the bonding requirements would not generally apply to a SEP or SIMPLE-IRA plan.⁸¹

Bonding Exception

An exception to the bonding requirement generally applies for a fiduciary (or a director, officer, or employee of the fiduciary) that is a corporation authorized to exercise trust powers or conduct an insurance business if the corporation is subject to supervision or examination by Federal or State regulators and meets certain financial requirements. The PPA provides an exception to the ERISA bonding requirement for an entity registered as a broker or a dealer under the Securities Exchange Act of 1934 if the broker or dealer is subject to

⁷⁹ ERISA Section 511, as amended by PPA Section 623(a). The provision is effective for violations occurring on and after August 17, 2006, the date the PPA was enacted. PPA Section 623(b).

⁸⁰ IRC Sections 416(i).

⁸¹ ERISA Sections 404(c), 412; DOL Reg. Sections 2510.3-3, 2550.412-5. 66 DOL Reg. Section 2510.3-102.

the fidelity bond requirements of a self-regulatory organization (within the meaning of the Securities Exchange Act of 1934).⁸²

In addition, the PPA raises the maximum bond amount from \$500,000 to \$1 million in the case of a plan that holds employer securities. A plan would not be considered to hold employer securities within the meaning of this section where the only securities held by the plan are part of a broadly diversified fund of assets, such as mutual or index funds.⁸³

Forwarding Contributions

Notwithstanding the deduction timing rules, ERISA regulations generally require that employee contributions be deposited as soon as they can reasonably be segregated from the employer's general assets, but in any event within 15 business days (30 days in the case of a SIMPLE IRA) after the end of the month in which the payroll deduction is made.⁸⁴ The 15- and 30-day periods are not safe harbors. Special considerations apply to partners. The forwarding requirements for elective contributions are more fully discussed in Chapter 20. Special deduction issues apply to a SIMPLE-IRA (see Chapter 3).

Example. Finicky Partners maintains a SARSEP or 401(k) plan and the relevant ADP test is satisfied. On December 31, 2007, the last day of its taxable year, each of the seven partners individually elects to defer the maximum amount into the plan (not to exceed \$15,500 per partner). During 2007, each partner had a monthly draw of \$3,300 cash against eventual earnings. Finicky Partners' accountant, Katrina, is ill and is unable to compute the partnership's net earnings by the due date of the partnership's tax return. He files for an automatic six-month extension on behalf of the partnership return (October 15, 2008). Each of the partners' returns is extended to at least that date. On September 27, 2008, the accountant notifies the partnership that it indeed had a profit and that each of the partners is due an additional \$20,000 distribution of profits. Finicky Partners must deposit \$108,500 (\$15,500 multiplied by 7) as contributions to the 401(k) trustee or custodian of the seven partners, as soon as they can be deposited, but no later than 15 business days after the end of September. For deduction purposes, the elective amounts and any nonelective employer contributions must be deposited by October 15, 2008, the extended due date of Finicky's 2007 tax return.⁸⁵ Assuming the ADP test was satisfied and none of the elective amounts exceeded an otherwise applicable limit, none of the elective contributions would be treated as catch-up contributions for those individuals age 50 or older by the end of the calendar year in which the plan year ended.

Example. Same facts as in the preceding example, except Katrina determines that each partner is only due an addition profit distribution of \$5,000. The monthly draw (\$3,300) has already been paid, so it cannot be considered for deferral purposes. Thus, only \$35,000 (\$5,000 × 7) may be deferred.

⁸² PPA Section 611(c); ERISA Section 412(a)(2), as amended by PPA § 611(b). The bonding exception provision is effective for plan years beginning on or after 2007.

⁸³ PPA Section 622(b), ERISA Section 412(i), as amended by PPA Section 412(a). The bonding provisions relating to employer securities is effective for plan years beginning on or after January 1, 2008.

⁸⁴ IRC Section 318(a)(1)(A)(ii).

⁸⁵ See, Treas. Reg. Section 1.401(k), Preamble; DOL Reg. Section 2510.3-102; Ltr. Rul. 200247052 (Aug. 28, 2002).

Minimum Required Distributions

The RMD rules, which generally require that distributions begin by the April 1 following the calendar year in which a plan participant attains age 70½, apply to IRAs, IRAs established under SEP, and qualified plans (such as a profit-sharing plan, or a profit-sharing plan with a 401(k) feature).

There is little difference in the application of the RMD distribution rules to these various types of plans. One key difference, however, is that an employee, other than a more than 5% owner-employee, who continues to work after the normal retirement date is not required to commence distributions in a qualified plan. Employees covered by a SEP are required to commence distributions regardless of whether they actually retire (the same rule as for IRAs). The RMD rules are more fully discussed in Chapter 14, “Required Minimum Distributions.”

Early Distributions

The 10 percent excise tax for early distributions may apply to distributions before age 59½ from IRAs as well as from IRAs established under a SEP. This topic and the exceptions from the penalty tax are discussed in Chapter 16, “Rollovers and Portability.”

Regular and Premature Distribution Taxation

Distributions of SEP contributions (including gain) are taxed in the same manner as traditional IRA distributions. Distributions are subject to federal income tax except to the extent of any basis attributable to nondeductible contributions. Distributions made prior to age 59½ may be subject to a 10 percent premature distribution excise tax unless any of the exceptions apply. Other rules may apply to SARSEP distributions and the removal of excess contributions.

Lump-Sum Distributions

Lump-sum distributions from qualified plans are eligible for favorable tax treatment. This special lump-sum distribution tax treatment is not available for distributions from IRAs, including distributions from IRAs established under a SEP. In addition, distributions from an IRA, including an IRA established under a SEP, were not allowed to be rolled over into a qualified plan for years before 2002, but can be rolled over beginning in 2002. Qualified plan distributions may, of course, be rolled over into an IRA under appropriate circumstances, and in the case of a conduit IRA (see Chapter 16), the original qualified plan distributions may effectively later be rolled over again into a qualified plan. In that case, the monies may be eligible for lump-sum distribution tax treatment (10-year forward income averaging and/or capital gains treatment for net unrealized appreciation in distributed employer securities) when distributed from the qualified plan after five years of participation in the plan.⁸⁶

If amounts are transferred directly from one qualified plan to another qualified plan, if the employee participated in either plan or both plans for a total of at least five taxable years before the taxable year in which

⁸⁶ Prop. Treas. Reg. Section 1.402(e)-2(e)(3).

the distribution is made from the transferee plan, the minimum five-year participation requirement may be satisfied.⁸⁷

Effective for distributions made after 2006, a nonspouse beneficiary of an inherited qualified plan account⁸⁸ may make a trustee-to-trustee transfer of part (or all) of the deceased employee's account balance in a qualified plan to an IRA set up for the purpose of receiving the distribution on behalf of the designated non-spouse beneficiary of the employee. Rollovers and transfers are more fully discussed in Chapter 16.

Loans

An individual may not borrow from an IRA, including an IRA established under a SEP, whether or not the individual is an owner/employee.

Termination of SEP Plan

Termination of a SEP is simpler than termination of a qualified plan. IRS approval is not required to terminate a SEP (or a SARSEP). If an employer wishes to permanently discontinue contributions including elective deferrals, it may amend the SEP (or SARSEP). A copy of the amendment, as well as an explanation of the amendment (and its effect on participants) must be given to participants. A nonelective SEP could just remain dormant.

Protection From Creditors

In the case of an IRA, including an IRA established under a SEP, there is generally no protection of those assets from creditors under state law, because IRS antialienation rules for qualified plans do not apply, and normally ERISA's antialienation rule will not apply. As with qualified plan assets, IRA assets are subject to IRS tax levies (although an exception to the 10 percent early distribution excise tax was recently added to the Code for such purpose).⁸⁹ Many states offer protection for IRAs, under which creditors of an IRA owner cannot gain access to the debtor's IRA amounts or have only restricted access to those amounts. For a SEP, however, state statutes protecting an individual's SEP IRA from his or her creditors, or exempting those assets from inclusion in the individual's bankruptcy estate, may be preempted by ERISA because a SEP, unlike an IRA, is generally subject to ERISA. This rationale leaves open the possibility that state laws protecting SEP assets from the reach of creditors will be preempted when the participant is not in bankruptcy. Creditor protection is more fully discussed in Chapter 18, "Creditor Protection."

Many types of retirement funds are protected in bankruptcy. However, for assets in an IRA or Roth IRA, other than those assets attributable to a SEP or a SIMPLE IRA, the aggregate value of such assets exempted may not exceed \$1 million in a case filed by a debtor who is an individual, except that such an amount may be increased if the interests of justice so require. The \$1 million cap does not apply to amounts attributable to

⁸⁷ Ltr. Rul. 8004092 (Oct. 31, 1979) permitted tacking of participation years under separate plans when entity incorporated and transferred assets from terminated Keogh plan into new corporate plan.

⁸⁸ Similar rules apply to eligible plans under IRC Section 457.

⁸⁹ IRC Section 72(t).

rollover contributions under IRC Sections 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8).⁹⁰ An unlimited exemption applies to amounts attributable to contributions made by an employer (including elective contributions) to a SEP IRA or SIMPLE IRA.⁹¹ Creditor protection is more fully discussed in Chapter 18.

Tax Credits

Tax Credit for Employers

A small business that adopts a new SEP (or SIMPLE) can generally claim an income tax credit for 50 percent of the first \$1,000 in administrative and retirement-education expenses for each of the first three years of the plan. The credit is available only to employers that did not have more than 100 employees with compensation in excess of \$5,000 during the previous tax year. The employer must have had at least one NHCE. The credit is taken as a general business credit on the employer's tax return. The other 50 percent of the expenses may be taken as a business deduction. The expenses must be paid or incurred in taxable years beginning after 2001 and with respect to plans established after 2001.⁹² The credit is more fully discussed in Chapter 1, "Introduction."

Tax Credit for Employees

For taxable years beginning after 2001, certain low-income taxpayers may receive a nonrefundable contribution credit for a percentage of their contributions. The credit is based on a sliding-scale percentage of up to \$2,000 contributed to a traditional IRA or Roth IRA; elective deferrals made to a SIMPLE, a SEP, a 401(k) plan, a 403(b) plan, or a 457(b) plan; and voluntary after-tax contributions to a qualified plan. The credit also applies to designated Roth 403(b) contributions and designated Roth 401(k) contributions that became effective in taxable years beginning after 2005. The credit is in addition to any other tax benefit (that is, the possible tax deduction) that the contribution gives the taxpayer.⁹³

To be eligible for the contribution tax credit, the taxpayer must be 18 years of age or older and must not be a full-time student or be claimed as a dependent on another taxpayer's tax return.⁹⁴

The amount of the credit for any year is reduced by any distribution taken during the testing period from a qualified plan, a 403(b) plan, a governmental 457(b) plan, or a traditional IRA, whether or not the distribution is taxable. The *testing period* consists of the two preceding taxable years, the taxable year, and the period after the taxable year and before the due date of the federal income tax return of the individual (and spouse of the individual if a joint return is filed) for the taxable year, including extensions.⁹⁵

Example. Tom requests an extension of time to file his 2007 tax return until October 15, 2008. Tom will be ineligible for a tax credit for 2007 if he took distributions totaling at least \$2,000 at any time between January 1, 2005, and October 15, 2008.

Example. Barbara takes an IRA distribution of \$2,000 on March 1, 2007. She is ineligible to claim the contribution tax credit for 2006, 2007, and 2008. Certain types of withdrawals, including the return of an

⁹⁰ 11 U.S.C. §§522(b)(1), 522(b)(2), 522(b)(3), 522(d), 522(n); see also 11 U.S.C. §522(d)(E)(10).

⁹¹ 11 U.S.C. §§522(b)(1), 522(b)(3)(C), 522(d) (referenced by §522(b)(2)).

⁹² IRC Section 45E.

⁹³ IRC Sections 25B(a), 25B(b).

⁹⁴ IRC Section 25B(c).

⁹⁵ IRC Section 25B(c).

excess contribution, a rollover, and a loan from an annuity contract, are not treated as distributions for this purpose.⁹⁶

Caution: Amounts withdrawn for first-time home purchases and for either medical or educational expenses may reduce or eliminate the credit for contributions or deferrals to retirement savings plans for the current year or future years even though they may not be subject to the 10 percent early withdrawal penalty

Credit rates are based on adjusted gross income (AGI) levels as outlined next.

Joint Filers		Heads of Household		All Other Filers [*]		Credit Rate
Over	Not Over	Over	Not Over	Over	Not Over	
\$ 0	\$31,000	\$ 0	\$23,259	\$ 0	\$15,500	50%
\$31,000	\$34,000	\$23,259	\$25,500	\$15,500	\$17,000	20%
\$34,000	\$52,000	\$25,500	\$39,000	\$17,000	\$26,000	10%
\$52,000	N/A	\$39,000	N/A	\$26,000	N/A	0%

* This column includes single filers and married filers filing separately. Unless corrected by a technical correction, this column also applies to surviving spouses. When it comes to computing this credit, EGTRRA puts a surviving spouse in an adverse position compared to a head of household.

Note. The PPA provides for indexing of the income limits applicable to the saver's credit beginning in 2007, which was also permanently extended by the PPA.⁹⁷

Example. Morty is married and files a joint tax return with his wife, Ann. Morty's AGI for 2007 is \$32,000. He contributes \$2,000 to an IRA or as an elective deferral to a SARSEP. His tax credit for 2007 is \$400 ($\$2,000 \times .20$). If Morty's contribution for 2007 is only \$1,500, his tax credit for 2007 will be \$300 ($\$1,500 \times .20$). If Morty contributed \$4,000 to his IRA for 2007, his credit amount remains at \$400 because only up to \$2,000 of contributions may be considered for purposes of the low-income contribution credit.

Example. Carla, who is not married, has an AGI of \$24,000 for 2007. Carla contributes (or makes an elective deferral of) \$1,000 to an IRA. Carla's tax credit for 2007 is \$100 ($\$1,000 \times .10$).

Although the contribution tax credit could be an incentive to contribute to a Roth IRA rather than to a traditional IRA, particularly if the credit could eliminate any income tax entirely, situations exist in which the IRS is paying for the traditional IRA contribution because the IRA deduction is included in the calculation of the AGI.

Example. Joseph and La Toya file a joint tax return. Each contributes \$2,950 to a Roth IRA for 2007. Their AGI is \$31,000. Because Joseph and La Toya are under age 50, their contribution limit for 2007 is \$4,000. They are entitled to a credit of \$1,180 ($\$5,900 \times .20$). If Joseph or La Toya contributes an additional \$100 to a traditional IRA, their AGI will become \$31,000 and the credit percentage will jump from 20 percent

⁹⁶ See IRC Section 25B(d)(2)(C).

⁹⁷ IRC Section 25B(h), stricken by PPA §812; IRC Section 25B(b).

to 50 percent. Their combined credit will increase from \$1,180 to \$3,000 ($\$6,000 \times .50$), giving them a \$1,820 reduction in tax for the additional IRA contribution.

Taxpayers qualify for the contribution tax credit even if they are over age 70; however, distributions, including RMDs, may make taxpayers ineligible for the credit. For older taxpayers, a Roth IRA or a transfer to an employer's plan (if the individual is not a 5 percent owner and is not retiring) might be a good idea.

Practice Pointer: The fact that the credit is available to spouses who file separate returns means that a lower-income spouse can qualify for the credit even if the couple's joint income is too high. For example, if a husband has an AGI of \$50,000 and the wife has an AGI of \$24,000, the wife qualifies for a credit of 10 percent of any qualified contribution on a separate return, even though the couple cannot take a credit for the contribution on a joint return.

Retirement Planning Advice Provided by Employers

EGTRRA clarifies that retirement planning advice provided by employers to employees (and their spouses) after 2001 on an individual basis is a nontaxable fringe benefit to the extent such services are made available on substantially equivalent terms to all employees.⁹⁸

Individualized Investment Advice

The PPA adds a new category of prohibited transaction exemption under ERISA and the Code in connection with the provision of individualized investment advice through an "eligible investment advice arrangement" to beneficiaries of IRAs and to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan (for example, a designated Roth contribution program). In the case of an eligible investment advice arrangement, the arrangement must be expressly authorized by a plan fiduciary other than the person offering the investment advice program, or any person providing investment options under the plan, and including an affiliate of either person. In general, if an eligible investment advice arrangement provides investment advice pursuant to a computer model, the model must satisfy several requirements. These requirements, transactions with service providers, as well as other ERISA considerations, are more fully discussed in Chapter 23.

Coercive Interference with ERISA Rights

ERISA prohibits any person from using fraud, force or violence (or threatening force or violence) to restrain, coerce, or intimidate any plan participant or beneficiary in order to interfere with or prevent the exercise of their rights under the plan. Willful violation of this prohibition is a criminal offense subject to fine or imprisonment.⁹⁹ See Chapter 23 for additional information.

⁹⁸ IRC Section 132(a)(7), 132(m)(1).

⁹⁹ PPA Section 623(a), amending ERISA Section 511.

Plan Correction Programs—EPCRS, VFPC, and DFVC

The IRS's Employee Plans Compliance Resolution System (EPCRS) and the DOL's Voluntary Fiduciary Correction Program (VFPC) are more fully discussed in Chapter 13, "Plan Correction Programs—EPCRS, VFPC, and DFVC." The EPCRS is a comprehensive system of integrated correction programs that plan sponsors may use to correct eligible failures and to continue providing their employees with retirement benefits on a tax-favored basis. VFPC allows certain persons to avoid potential civil actions, penalties, and the assessment of civil penalties under ERISA. In general, the exemption affects plans, participants, and beneficiaries of such plans in connection with investigation or civil action by the DOL.

The Delinquent Filer Voluntary Compliance Program (DFVC) is designed to encourage voluntary compliance with the annual reporting requirements under ERISA and is also discussed in Chapter 13.

SEP Compared to a Qualified Plan

A SEP program can compare favorably with a qualified plan even though fully vested SEP contributions would generally be made for transient employees with *three* or more years of service. A qualified plan's shorter eligibility requirement (generally a requirement of one year and 1,000 hours-of service) *may* result in contributions having to be made or allocated to more employees. Although the qualified plan would most likely have a vesting schedule applied to employer-derived accrued benefits or account balances, the schedule is applied to an additional two years of contributions made by the employer. The plan that offers the least employee cost at all points along an employee's employment time line can be identified only after considering many factors, including the potential growth of the business, the age of the employee, employee turnover, whether the employee was employed on the last day of the plan year, whether the employee worked at least 500 or 1,000 hours, work patterns, and so on. In addition, there must be an analysis of a group's eligibility to participate initially and then to receive contributions (and the extent to which those contributions will be vested upon an employee's termination of service).

SEP Advantages and Disadvantages

SEPs provide a number of advantages, as well as disadvantages. Each are discussed in the following sections.

SEP Advantages

The advantages of SEP are as follows:

- SEP plans are easy to establish, and their enumerated administrative burdens are minimal, especially if the IRS model is used.
- SEP plans are easy to understand and communicate to employees.
- SEP disclosure notice is only required initially and whenever the SEP is amended.
- SEP plans have limited fiduciary liability.
- SEP plans are cost-effective.
- SEP plans are less burdensome to administer than qualified plans.

- Contributions may be as high as \$45,000 (\$50,000 with catch-up contributions under a SARSEP) for 2007.
- Contributions may be changed from year to year and, unlike under a qualified plan, need not be recurring; that is, an employer can make a contribution simply for one or two years, without the need to make contributions in any succeeding years.
- Minimal reporting requirements apply (the assets are held and accounted for by the IRA custodian or trustee); in particular, Form 5500 and summary plan descriptions normally are not required.
- An employer may adopt a SEP on or before the deadline for filing the employer's federal income tax return for the year for which the employer wishes to take a deduction; this is in contrast to the requirement that a qualified plan be adopted by the last day of the employer's taxable year for which the plan is to be effective.
- In determining whether a SEP is top heavy, an employer may elect that the SEP count only aggregate employer contributions (presumably for all years), rather than the total amount in employees' accounts. This election (or default) may be contained in the SEP document established by the employer.
- There are no vesting schedules for SEPs. Vesting is 100 percent and immediate.
- SEP contributions may be integrated with Social Security benefits, thereby increasing the percentage of total contributions allocated to HCEs.
- Elective (including catch-up) contributions are deductible in addition to the 25 percent of preplan aggregate compensation deduction limit.
- For HCEs only, the \$45,000 (for 2007) limit is reduced if the plan is integrated with Social Security.

SEP Disadvantages

An employer wishing to ensure that employees will not spend their retirement monies prior to retirement should establish a qualified plan under which distributions are not permitted prior to some retirement age, such as age 65. Under an IRA, including an IRA established under a SEP, employees have an unfettered right to withdraw monies from their IRAs at any time, although they may face a 10 percent penalty for premature distribution. The following are also disadvantages:

- Most employees, including part-time employees, who have worked during three of the last five years, must receive a contribution.
- Contributions are nonforfeitable (vested) when made.
- Leased employees generally must be covered.
- Deductible contributions in excess of a participant's 25 percent of includable compensation may have to be included in the participant's gross income.
- Employees can remove monies from their accounts immediately, leaving them with no funds at actual retirement.
- Loans are not permitted.
- Creditors of employees may be able to gain access to SEP assets (although perhaps not in cases in which the employee becomes bankrupt or applicable state law shields SEP amounts from the employee's creditors in bankruptcy).
- Employees cannot be required to be employed on the last day of the year, or to work a minimum number of hours during the year, in order to receive a contribution.

- Investments are limited by IRA rules and must be held by an IRS-approved trustee or a custodian.
- Life insurance may not be held in a SEP.
- No lump-sum distribution or 10-year averaging of capital gains treatment is available for distributions.
- Employee pretax elective contributions are permitted only if there are no more than 25 eligible employees in the preceding plan year and at least 50 percent of eligible employees choose to make pretax contributions; in addition, discrimination tests apply to each HCE on an individual basis, rather than on the basis of average contributions made by HCEs (as under a qualified 401(k) plan); no matching contributions are permitted on pretax deferrals to a SEP.
- Unlike for qualified plans, there is no exception from the early distribution tax for distributions (1) after separation from service after attaining age 55, (2) for deductible medical expenses, or (3) to alternate payees under a qualified domestic relations order. On the other hand, the early distribution tax exception for periodic payments applies whether or not the individual has separated from service, whereas for qualified plans that exception applies only for payments beginning after the employee's separation from service.
- The SEP is required to include employees who earn less than \$500 (the 2007 limit) during the plan year ending in 2007.
- Employer may not make matching contributions.

Exhibit 2-1. SEP Checklist for 2007

Every year it is important that the requirements for operating a simplified employee pension (SEP) be reviewed. The following list is a “quick tool” to help keep a SEP in compliance with many of the important tax rules. This list is not a complete description of all plan requirements, and should not be used as a substitute for a complete plan review.

	YES	NO
1. Are all eligible employees participating in the SEP? <i>Any employee who is at least 21 years of age, was employed by the employer for 3 of the immediately preceding 5 years, and received compensation from the employer of at least \$500 during the year (the 2007 limit) is eligible to participate in a SEP.</i>	<input type="checkbox"/>	<input type="checkbox"/>
2. Does the SEP cover all businesses that the owner and/or his or her family members own? <i>Employees of other businesses that the business owner and his or her family members own may have to be treated as employees when determining who is an eligible employee under the SEP.</i>	<input type="checkbox"/>	<input type="checkbox"/>
3. Have all eligible employees been given information about the SEP? <i>The plan sponsor (generally the employer) must give its employees certain information about the SEP, including a copy of the SEP document. Form 5305-SEP is the SEP document if using the IRS's model form.</i>	<input type="checkbox"/>	<input type="checkbox"/>
4. Is an eligible employee's compensation determined using an appropriate definition in accordance with the SEP document? <i>Compensation used to determine contributions must also be limited to \$225,000 for 2007, and is subject to cost-of-living adjustments in later years.</i>	<input type="checkbox"/>	<input type="checkbox"/>
5. Are contributions made only to a traditional IRA? <i>All SEP contributions must go to traditional IRAs established for the eligible employees.</i>	<input type="checkbox"/>	<input type="checkbox"/>
6. Are SEP contributions to each employee's IRA limited as required by law? <i>Contributions to a SEP-IRA are limited to the lesser of 25 percent of the employee's compensation for the year or \$45,000 for 2007, and is subject to cost-of-living adjustments for later years.</i>	<input type="checkbox"/>	<input type="checkbox"/>
7. Are employer contributions immediately 100 percent vested? <i>Employer contributions cannot be conditioned on anything. Once made, the employee owns all contributions.</i>	<input type="checkbox"/>	<input type="checkbox"/>
8. If required, have top-heavy minimum contributions been made to the SEP? <i>If a SEP is top-heavy or deemed top-heavy, contributions must be made for the nonkey employees equal to the lesser of 3 percent of compensation or a percentage equal to the highest contribution rate of any key employee.</i>	<input type="checkbox"/>	<input type="checkbox"/>
9. For deduction purposes, were employer contributions deposited on time? <i>An employer has until the due date, including extensions, of its tax return to deposit employer contributions in order to obtain a deduction.</i>	<input type="checkbox"/>	<input type="checkbox"/>
10. If the model Form 5305-SEP was used to set up the plan, is this SEP the business's only employee retirement plan? <i>A sponsor of a SEP established using model Form 5305-SEP cannot sponsor another retirement plan, such as a 401(k) plan.</i>	<input type="checkbox"/>	<input type="checkbox"/>

If “No” was the response to any of the above questions, mistakes were made in the operation or administration of the SEP. Many mistakes can be corrected easily, without penalty and without notifying the IRS (see Chapter 13).

Exhibit 2-2. SARSEP Checklist for 2007

Every year it is important that the requirements for operating a salary reduction simplified employee pension (SARSEP) be reviewed. The following list is a "quick tool" to help keep a SARSEP in compliance with many of the important tax rules. This list is not a complete description of all plan requirements, and should not be used as a substitute for a complete plan review.

	YES	NO
1. Was the SARSEP established prior to January 1, 1997, and subsequently amended for current law? <i>No new SARSEPs can be established after 1996. SARSEPs should be updated to benefit from the new law.</i>	<input type="checkbox"/>	<input type="checkbox"/>
2. Does the employer have 25 or fewer eligible employees? <i>Only businesses with 25 or fewer eligible employees can contribute to a SARSEP.</i>	<input type="checkbox"/>	<input type="checkbox"/>
3. Are all eligible employees participating in the SEP? <i>An employee who is at least 21 years of age, was employed by the employer for 3 of the immediately preceding 5 years, and received compensation from the employer of at least \$500 during the year (2007) is eligible to participate in a SEP.</i>	<input type="checkbox"/>	<input type="checkbox"/>
4. Is the business that the SEP covers the only business that owner and/or his or her family members own? <i>Employees of other businesses that the business owner and his or her family members own may have to be treated as employees when determining who is an eligible employee under this SEP.</i>	<input type="checkbox"/>	<input type="checkbox"/>
5. Have all eligible employees been given information about the SARSEP? <i>All eligible employees must receive certain information about the SARSEP, including a copy of the SARSEP document. Form 5305A-SEP is the SARSEP document if using the model form.</i>	<input type="checkbox"/>	<input type="checkbox"/>
6. Are all employee elective deferrals within the appropriate limit: \$15,500 for plan years that end in 2007? <i>For employees age 50 or over, additional catch-up contributions of up to \$5,000 can be made for 2007.</i>	<input type="checkbox"/>	<input type="checkbox"/>
7. Do 50 percent or more of all eligible employees make employee elective deferrals? <i>At least half of all eligible employees must make employee elective deferrals to the SARSEP.</i>	<input type="checkbox"/>	<input type="checkbox"/>
8. Are total contributions (employee elective deferrals and nonelective employer contributions) no more than 25 percent of compensation? <i>For 2007, contributions are limited to the 25 percent of compensation, but not more than \$45,000. The dollar amount is adjusted annually for changes in the cost of living. SARSEPs do not permit employers to make matching contributions to participants' accounts.</i>	<input type="checkbox"/>	<input type="checkbox"/>
9. Were employee elective deferrals deposited on time? <i>Employee elective deferrals must be remitted to the appropriate financial institution as soon as possible but, in any event, no later than 15 days following the month in which the employee would have otherwise received the money. Remittance within a period as short as 1 day may be reasonable under some circumstances.</i>	<input type="checkbox"/>	<input type="checkbox"/>
10. Was the annual average deferral percentage test performed? <i>The amount deferred each year by each highly compensated employee as a percentage of pay (the deferral percentage) cannot exceed 125 percent of the average deferral percentage (determined separately) of eligible nonhighly compensated employees (NHCE). If there are no NHCEs, the deferral test is automatically satisfied.</i>	<input type="checkbox"/>	<input type="checkbox"/>
11. Are top-heavy minimum contributions required to be made to the SARSEP? <i>Refer to the plan document for information. Plans using the model IRS Form 5305A-SEP are deemed top-heavy if a key employee participates. Most other plans (e.g., a prototype SARSEP) require annual testing.</i>	<input type="checkbox"/>	<input type="checkbox"/>

If "No" was the response to any of the above questions, mistakes were made in the operation or administration of the SARSEP. Many mistakes can be corrected easily, without penalty and without notifying the IRS (see Chapter 13).

Chapter 3

SIMPLE Plans

A savings incentive match plan for employees (SIMPLE) is a simplified retirement plan for small businesses that allows employees to make elective pretax contributions and requires employers to make matching or, alternatively, nonelective contributions. A SIMPLE may be part of a 401(k) plan or it may be used as an individual retirement account or annuity (IRA). When it is used as an IRA, it is known as a SIMPLE IRA. See comprehensive illustrations in Appendix A, “Plan Feature Comparison Charts.”

Contributions are limited to employee elective contributions and required employer matching contributions or nonelective contributions. No other contributions are permitted, except rollovers from another SIMPLE IRA.

SIMPLE IRA Plans

A SIMPLE IRA plan is an IRA that satisfies several additional rules and also includes a qualified salary-reduction arrangement.¹ The plan under which contributions are made is called a SIMPLE to distinguish it from a SIMPLE arrangement established in the form of a qualified 401(k) plan (called a 401(k) SIMPLE), which are separately discussed below. When established in IRA form, many of the qualified plan rules do not apply.

Each employee decides whether to contribute and in that way reduce the amount of his or her compensation for tax purposes, as well. Contributions are made by the employer to an IRA, called a SIMPLE IRA, to which the only contributions that may be made are contributions under a SIMPLE IRA plan and rollovers or transfers from another SIMPLE IRA. No other types of contributions are permitted to be made under a SIMPLE.

Each contributing employee may choose whether to have the employer make payments as contributions under the SIMPLE IRA plan or to receive these payments directly in cash.

¹ The provisions relating to SIMPLEs are effective for years beginning after December 31, 1996. The Small Business Job Protection Act of 1996 (SBJPA, Public Law 104-188) was signed by President Bill Clinton on August 20, 1996. See SBJPA Section 1421.

Employer Eligibility

A SIMPLE-IRA plan may be established by an eligible employer but generally must be the only plan maintained by that employer. The following types of business entities are eligible to establish a SIMPLE:

- Corporations
- Partnerships
- S corporations
- Sole proprietors (individuals who own the entire interest in an unincorporated trade or business operated for profit)
- Limited liability companies (LLCs)
- Limited liability partnerships (LLPs)
- Nonprofit and government entities

The term *plan* includes a qualified plan or annuity, a governmental plan, a tax-sheltered annuity or custodial account, a simplified employee pension (SEP), or a simple retirement account.²

Example. Mega Incorporated and Merger Incorporated are both owned by Buddy. The entities are located in different states. They each adopt a separate SIMPLE. Notwithstanding that both Mega and Merger are treated as a single employer, the adoption of a second *plan* invalidates the adoption of both SIMPLE plans.

SIMPLE IRA Requirements

The general requirements for a SIMPLE established in the form of an IRA are the following:

1. The employer must be an eligible employer for the calendar year. Although a tax-exempt employer may *not* maintain a salary-reduction or elective SEP (SARSEP), it may establish a SIMPLE. A governmental employer may also establish a SIMPLE (if allowed by state enabling statutes).³
2. The only contributions permitted are contributions under a qualified salary-reduction arrangement.⁴
3. All contributions must be fully vested.⁵
4. Eligible employees must have the option to participate.⁶
5. Special administrative requirements must be satisfied (for example, each eligible employee must be notified at least 60 days before the election period that he or she may make or change a salary-reduction election and whether he or she may elect the financial institution that will serve as trustee or custodian of the plan).⁷

² IRC Sections 219(g)(5), 408(p)(2)(D).

³ Notice 98-4, Q&A B-4 (1998-2 IRB 26).

⁴ IRC Section 408(p)(1).

⁵ IRC Section 408(p)(3).

⁶ IRC Section 408(p)(4)(A) and (B).

⁷ IRC Section 408(p)(3).

The Employer

The term *employer* includes all related employers. All related employers should adopt the SIMPLE by affixing their signatures to the SIMPLE agreement (and by adopting a written resolution if necessary). A *related employer* is either a member of an affiliated service group, a controlled group of corporations, or a trade or business under common control.⁸ In other words, all employees of all employers that are related are *treated* as if employed by a single employer for SIMPLE purposes. An exception is provided, however, if an employer becomes or ceases to be related. The exception only applies during the transition period which begins on the date of the change in members of the group and ends on the last day of the first plan year beginning after the date of such change. In general, if the coverage requirements were satisfied before each change and coverage under the plan is not significantly changed during the transition period (other than change by reason of the change in members of the group), the participation rules will continue to be satisfied during the transition period.⁹

Example. Primary Insurance has 60 employees, who all participate in a SIMPLE IRA. Berry Insurers, an unrelated employer, maintains a qualified plan for its 80 eligible employees. On May 1, 2007, Primary purchased Berry and became the parent in a parent-subsidary controlled group. Primary may continue to maintain its SIMPLE IRA for its 60 employees, as well as future eligible employees from May 1, 2007, to December 31, 2008. Coverage under the SIMPLE IRA may not be significantly changed, and only individuals who would have been employees of Primary had the transaction not occurred may participate.

Special complications arise if an employer maintains more than one SIMPLE or makes contributions to a qualified plan. As previously stated, a SIMPLE generally must be the employer's only plan. If elective contributions are made to more than one plan of an employer or multiple employers (other than an eligible 457 plan), the limit under Internal Revenue Code (IRC or the Code) Section 402(g), \$15,500 for 2007, generally applies, even though elective SIMPLE contributions cannot exceed \$10,500 plus catch-up contributions (up to \$2,500) for 2007.

SIMPLE Plan Adoption

An employer can establish a SIMPLE IRA plan by adopting either (1) an IRS model agreement, using Form 5304-SIMPLE or Form 5305-SIMPLE; (2) a prototype SIMPLE IRA sponsored by a qualified financial institution (for example, a bank or insurance company); or (3) an individually designed plan.

A prototype or model SIMPLE plan must be used with an IRS model SIMPLE IRA (Form 5305-S or 5305-SA) or an IRS-approved prototype SIMPLE IRA.¹⁰

In March 2002, the IRS issued new model SIMPLE forms that have been amended for EGTRRA and the required minimum distribution (RMD) regulations. Beginning October 1, 2002, these amended model forms must be used to establish new SIMPLE IRA plans and new model SIMPLE IRAs. Model SIMPLE IRA plans existing at that date were required to be amended for EGTRRA and adopted by employers by December 31, 2002. This step required an employer signature. Employees were not required to sign the document to adopt the SIMPLE IRA. A mass mailing of the new document to employees was sufficient.¹¹

⁸ IRC Section 414(b), (c), (m) or (o).

⁹ IRC Section 410(b)(6)(C); see Rev. Rul. 2004-11 (2004-7 IRB 480) regarding the transition rule on a pension and profit-sharing plan following a sale of subsidiary stock to an unrelated employer.

¹⁰ Rev. Proc. 87-50 (1987-2 CB 647); Rev. Proc. 97-29 (1997-1 CB 698).

¹¹ Rev. Proc. 2002-10 (2002-4 IRB 401); IRS Ann. 2002-49 (2002-19 IRB 919).

Form 5305-SIMPLE was revised in August 2005. An employer is not required to execute the August 2005 version if the employer had executed the March 2002 version of the form.

Effective Date

The *effective date* is the date that the provisions of a plan become effective. Except for the first plan year that the employer is adopting a SIMPLE IRA, the effective date must be January 1.¹²

In all other cases, the effective date cannot be any later than October 1. Special rules, however, apply to new employers that are formed after October 1. The effective date is used primarily for determining the required 60-day enrollment period.¹³

100-Employee Rule

Employers who employed 100 or fewer employees who earned \$5,000 or more in compensation for the preceding calendar year are generally eligible to adopt a SIMPLE IRA. Although an employer may elect to exclude employees covered under a collective bargaining agreement for which retirement benefits were the subject of good-faith bargaining, those employees are nonetheless included for the purpose of the *100-employee limitation*. Any type of business entity can establish a SIMPLE IRA, including tax-exempt employers and governmental entities.¹⁴ Employees include self-employed individuals (owners of unincorporated businesses) who received earned income from the employer during the year.¹⁵

Caution: *For purposes of the 100-employee limitation, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE. Thus, certain unionized employees who are excludable under the rules of IRS Section 410(b)(3), nonresident alien employees, and employees who have not met the plan's minimum eligibility requirements must be taken into account. Any such employee, however, can be excluded for the purpose of determining the employee's eligibility to participate.*¹⁶

Exclusive Plan Requirement

Except for a plan whose only participants are employees covered under a collective bargaining agreement (and who are excluded from participating in the SIMPLE IRA plan), an employer may not maintain a SIMPLE if it maintains another qualified plan, a SEP, a SARSEP, or a 403(b) tax-sheltered annuity plan.¹⁷ Furthermore, an employer may not maintain more than one SIMPLE.¹⁸

Example. In 1992, Christine Manufacturing, Inc., the plan sponsor, established a money purchase pension plan for employees who perform work subject to prevailing-wage rates under the Davis-Bacon Act. In 2007, the IRS selected for a limited scope audit the money-purchase pension plan's Form 5500, Annual Return/Report for Employee Benefit Plan. In handling the audit, the sponsor's third-party administrator (TPA), who has expertise in the qualified plan area, learned that the plan sponsor had adopted a SIMPLE IRA plan on a company-wide basis in 2003 intended to satisfy the requirements of IRC Section 408(p). The plan sponsor had established the plan on the basis of a good-faith, but erroneous belief that its qualified plan for

¹² IRC Section 408(p)(6)(C).

¹³ IRC Section 408(p)(5).

¹⁴ IRC Section 408(p)(2)(C)(i).

¹⁵ IRC Section 408(p)(6)(B).

¹⁶ IRC Sections 401(c)(1), 408(p)(2)(C)(i)(I), 408(p)(4)(B).

¹⁷ IRC Section 408(p)(2)(D)(i).

¹⁸ IRC Section 219(g)(5).

prevailing wage employees under the Davis-Bacon Act satisfied the exception to the exclusive-plan rule in IRC Section 408(p)(2)(D), relating to plans maintained for collectively bargained employees. Unbeknown to its TPA and other advisers, the plan sponsor maintained and made contributions to the money-purchase pension plan for every calendar year that the SIMPLE IRA was in existence (2003 through 2007). Christine Manufacturing is not eligible to maintain a SIMPLE IRA plan; thus, the SIMPLE IRA contributions (employee salary deferrals and employer matching contributions made on behalf of employees) are rendered nondeductible or prohibited excess contributions in each of those years. The Employee Plans Compliance Resolution System (EPCRS)¹⁹ can be used to correct this failure. See Chapter 13, “Plan Correction Programs—EPCRS, VFCP, and DFVC.”

Acquisitions, Dispositions, and Similar Transactions

Special rules called the *grace-period rules* apply upon an employer’s acquisition, disposition, or similar transaction for purposes of (1) the 100-employee limit, (2) the exclusive plan requirement, and (3) the service and compensation coverage rules for participation. In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary-reduction arrangement for the year of the transaction and the two following years, provided (1) such requirements were met immediately before each such change and (2) such arrangement would satisfy the requirements to be a qualified salary-reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.¹⁹

Example. Jordan owns Amber, a computer rental agency that has 80 employees, each of whom received more than \$5,000 in compensation in 2007. Jordan also owns Bright, a company that repairs computers and has 60 employees who received more than \$5,000 in compensation in 2007. Jordan is the sole proprietor of both businesses. IRC Section 414(c) provides that the employees of partnerships and sole proprietorships that are under common control are treated as employees of a single employer. Thus, for purposes of SIMPLE rules, all 140 employees are treated as being employed by Amber. As a result, neither Amber nor Bright is eligible to establish a SIMPLE for 2007.

Example. Cobra Company employed 90 individuals during 2007 and 2008. It establishes a SIMPLE IRA for 2008 for employees who earned at least \$5,000 from Cobra during any two previous years. During 2009, Cobra hires 50 additional employees. All employees earn at least \$5,000. If it were not for the grace period, Cobra would not be eligible to maintain a SIMPLE for 2010 because it employed more than 100 employees earning at least \$5,000 in 2009 (the preceding year).

Example. Blueberry Corporation employed 90 individuals during 2005 and 2006. All employees earn at least \$5,000. Blueberry establishes a SIMPLE IRA for 2007 for those employees who earned at least \$5,000 from the company during any two previous years. During 2007, Blueberry hires 50 new employees. Although Blueberry would be ineligible to initially establish a SIMPLE for 2008 because it had more than 100 employees earning at least \$5,000 during 2007, it may continue to maintain its existing SIMPLE during the two-year grace period (that is, for 2008 and 2009).

Example. Roller Skate Company employed 85 individuals during 2005 and 2006. All employees earn at least \$5,000. Roller Skate establishes a SIMPLE IRA for 2007 for employees who earned at least \$5,000 from the company during any two previous years. Sixty of the original 85 employees quit during the first half of 2007. During the second half of 2007, Roller Skate hired 50 additional employees. Roller Skate would not be

¹⁹ IRC Sections 408(p)(10), 410(b)(6)(C)(i)(II).

an eligible employer for 2008 if it were not for the grace period (because it had more than 100 employees during 2007 with compensation of \$5,000 or more).

Exclusive Plan Requirement

An employer that maintains a SIMPLE during any part of the calendar year may generally not maintain a qualified plan with respect to which contributions are made or benefits are accrued for service in that calendar year. For this purpose, a qualified plan includes, for example, a SEP, SARSEP, profit-sharing plan, money-purchase pension plan, or defined benefit pension plan.²⁰ An employer that maintains more than one SIMPLE plan is also in violation of the exclusive plan requirement.²¹ A qualified plan, however, whose only participants are employees covered under a collective bargaining agreement is disregarded if these employees are excluded from participating in the SIMPLE IRA plan.

Example. Sid owns 95 percent of Marvin Gardens Company and 87 percent of Charles Place Corporation. Marvin Gardens established a SIMPLE IRA for its employees specifying a prior year's compensation requirement of \$2,000. To avoid covering some of the employees in Charles Place, Marvin Gardens establishes a second SIMPLE IRA that specifies a \$5,000 prior year's compensation requirement. Because both Marvin Gardens and Charles Place are part of a controlled group, and thus are treated as a single employer, neither of the plans passes muster because the exclusive plan requirement has been violated.

Employee Eligibility Requirements

Each employee, regardless of age, who received at least \$5,000 in compensation from the employer during any two preceding calendar years (whether or not consecutive) and who is *reasonably expected* to receive at least \$5,000 in compensation during the calendar year must be eligible to participate in the SIMPLE IRA plan for the calendar year.²² For purposes of the SIMPLE IRA, compensation includes wages, tips, and any other pay from the employer subject to income tax withholding and deferred amounts that were elected in that year under any 401(k), 403(b), governmental 457(b) plan, SEP, or SIMPLE.

A self-employed individual's compensation for the year is his or her net earnings from self-employment (NESE) before subtracting any contributions made to a SIMPLE IRA on his or her behalf.²³ However, a self-employed individual may use only 92.35 percent of his or her NESE because of the 7.65 percent *in lieu of* deduction used in computing NESE.²⁴

Excluded Employees

An employer may elect to exclude the following employees from participation:²⁵

1. An employee covered under a collective bargaining agreement for which retirement benefits were the subject of good-faith bargaining.
2. An employee who is a nonresident alien and received no earned income from sources within the United States.

²⁰ IRC Section 408(p)(2)(D)(ii).

²¹ IRC Section 219(g)(5).

²² IRC Section 408(p)(4).

²³ IRC Section 408(p)(6)(A)(i).

²⁴ IRC Section 408(p)(6)(A)(ii).

²⁵ IRC Sections 408(p)(4)(B), 410(b)(3).

3. An employee who would not have been an eligible employee if an acquisition, disposition, or similar transaction had not occurred during the year.

An employer may impose less restrictive eligibility requirements by eliminating or reducing the service requirement, the prior-year compensation requirement, the current-year compensation requirement, or all three.

Example. Sherri, the owner and only employee of a newly established small business, creates a SIMPLE IRA plan using a model SIMPLE for 2007. The plan does not have a service requirement. A new employee, Muffin, is hired in June 2006, and Sherri amends the plan to provide for one year of service so that Muffin will not be eligible to participate until the following year. In 2007, Sherri duly amends the plan, this time providing for a two-year service requirement. Again, Muffin is ineligible. It is not known whether such a rolling eligibility period will pass IRS scrutiny.

Example. Brad's employer maintains a SIMPLE IRA plan in 2007. The plan uses the maximum service provision (two years) and the maximum compensation amount (\$5,000) for determining eligibility. Brad earned \$10,000 in 1999 and 2000 but did not perform any service during 2001, 2002, and 2003. During 2004 and 2005, Brad earned \$2,600 each year. Brad is reasonably expected to earn \$7,000 in 2007. He is therefore eligible to participate in the plan in 2007 because he can reasonably be expected to earn at least \$5,000 in compensation during the current year, and he has already earned \$5,000 in two previous years.²⁶

Example. Veronica has been a full-time employee of the Indomitable Ice Company for 18 years. Her annual salary is \$36,000. Shortly before the plan's election period (November 2 to December 31), Veronica requests and is granted an 11-month personal leave of absence to start on January 1, 2007. For 2007, Veronica is reasonably expected to earn only \$3,000 and will not be eligible to participate in the SIMPLE for 2007 if the company imposes a current compensation requirement in excess of \$3,000.

Example. The facts are the same as those in the preceding, except that (1) on January 2, 2007, Veronica decides not to take the leave of absence; (2) Indomitable Ice had duly elected to make the 2 percent nonelective contribution; and (3) the plan requires that an employee must be "reasonably expected" to have \$5,000 of current compensation to participate but requires only that an employee have \$2,000 of current compensation to receive a nonelective contribution. Veronica is not entitled to receive a nonelective contribution because she was not an eligible employee; that is, she was not reasonably expected to earn \$5,000 (even though she did earn more than \$2,000).

Participation in More Than One Plan

An employee may participate in a SIMPLE IRA plan even if the employee also participates in a plan of an unrelated employer for the same year. However, the employee's salary-reduction contributions generally are subject to an aggregate calendar-year limit of \$15,500 plus catch-up contributions on elective deferrals for 2007. It should be noted that the elective deferral limit applies separately to an eligible 457(b) plan.²⁷ Thus, catch-up contributions made to a governmental 457(b) plan do not reduce catch-up contributions in other types of plans (that is, 403(b), 401(k), SIMPLE, or SARSEP plans).

²⁶ IRC Section 408(p)(4)(A), 408(p)(6)(B).

²⁷ IRC Section 402(g)(3).

Maximum Age Restrictions

There are no maximum age restrictions. Eligible employees may participate in a SIMPLE IRA plan regardless of their age. Unlike contributions to a traditional IRA, SIMPLE contributions may be made by an employer to a SIMPLE IRA of an eligible employee after the employee reaches age 70½.

Note. The maximum \$15,500 annual limit that applies to exclusions of salary reductions and other elective deferrals in qualified and other types of plans under IRC Section 402(g) also applies on an individual level.²⁸ Therefore, if an employee is a participant in any other employer plans during the year and has elective salary reductions or deferred compensation under those plans, the salary-reduction contributions under the SIMPLE plan are also included in the \$15,500 annual limit.²⁹

Caution: *The IRS has determined that the employee, not the employer, is responsible for ensuring these requirements are not violated when the employee makes elective (pretax) contributions to qualified plans of unrelated employers. Therefore, the employee cannot rely on the employer's determining whether the elective limit has been exceeded due to salary exclusions under the plans of one or more other employers.*

An Employee

Only a common-law employee of the employer may participate in a SIMPLE IRA plan. The term *employee* also includes self-employed individuals (including partners in a partnership) and leased employees (as described in IRC Section 414(n)) but does not include nonresident aliens who receive no income from sources within the United States. An *eligible employee* means an employee who satisfies the age and compensation requirements (if any are set by the employer).³⁰

Domestic and Similar Workers

Currently, an employer may make a contribution on behalf of domestic and similar workers other than the employer or a member of the employer's family. The employer, however, is not afforded a deduction, because such contributions are not made in connection with a trade or business. For taxable years beginning after 2001, EGTRRA allows such contributions to be made on a nondeductible basis, and the 10 percent excise tax on nondeductible contributions does not apply to a SIMPLE 401(k) or a SIMPLE IRA solely because the contributions are not a trade or business expense.³¹

Caution: *This provision is intended to apply only to employers that have paid and continue to pay all applicable employment taxes, but the statute does not include this limitation.³² Similar provisions were not made for a SEP or a SARSEP covering only a domestic or household worker. Thus, the nondeductible contribution to a SEP or a grandfathered SARSEP may be subject to a 10 percent penalty.³³*

²⁸ IRC Section 402(g)(1).

²⁹ IRC Section 402(g)(8).

³⁰ IRC Section 408(p)(4)(A), 408(p)(6)(B).

³¹ IRC Section 4972(c)(6). See IRC Sections 3101, 3111, 3121(a)(7), 3121(a)(10), and regulations thereunder, regarding FICA treatment for payment for services for home worker service, and for services not in the course of an employer's trade or business.

³² EGTRRA Section 637; H.R. Conf. Rep. 107-51, pt. 1 (2001).

³³ IRC Section 4972(d)(1)(iv).

Compensation

Compensation used for SIMPLE IRA plan purposes means the sum of the wages, tips, and other compensation from the employer subject to federal income tax withholding and the employee's salary-reduction contributions made under the plan, and if applicable, elective deferrals under a 401(k) plan, a SARSEP, or a IRC Section 403(b) tax-sheltered annuity or custodial account, and compensation deferred under a 457 plan required to be reported by the employer on Form W-2, Wage and Tax Statement.³⁴

For a self-employed individual (including a partner in a partnership), compensation means the NESE determined under IRC Section 1402(a) prior to subtracting any contributions made by the self-employed individual. In computing NESE, that section provides for an in lieu of deduction of 7.65 percent; thus, only 92.35 percent of the NESE (before the application of the in-lieu of deduction) is treated as compensation.

Compensation earned before a new plan's effective date cannot be ignored or prorated.³⁵ This is important in determining the amount of compensation that is considered by the employer in making its contribution. Thus, compensation for the entire calendar year must be used.

Practice Pointer: For years beginning after 2001, the definition of compensation includes an individual's net earnings that would be subject to taxes under the Self-Employment Contributions Act (SECA) but for the fact that the individual is covered by a religious exemption.³⁶

Note. After 2001, if a nonresident alien is a regular member of a crew on a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States, the compensation received by the nonresident alien is not considered U.S. source income for purposes of a SIMPLE IRA (or any qualified retirement plan, including a SEP, a SIMPLE IRA, and a SARSEP).³⁷

Vesting

Because employees' accounts are maintained in their own IRAs, employees are fully vested in all amounts contributed on their behalf.³⁸

Employee Contributions

An employee may make annual elective contributions of up to \$10,500 for 2007 plus catch-up contributions. Employer contributions (including pretax elective contributions made by employees) are made in SIMPLE IRAs generally established by eligible employees. A traditional IRA may not be used in connection with a SIMPLE of an employer. An employer may not reduce the elective amount that may be contributed to an amount less than \$10,500 plus the \$2,500 catch-up contribution limit for 2007. Elective contributions may be made from amounts that would have otherwise been payable in cash (including bonuses) for the year.

The maximum annual elective deferral limit for a SIMPLE IRA increases from \$7,000 (the 2002 limit) beginning after 2001, as follows:³⁹

³⁴ IRC Sections 408(p)(6)(A), 6051(a)(3), 6051(a)(8).

³⁵ Treas. Reg. Section 1.401(a)(17)-1(b)(3); Notice 98-4, Q&As D-4, I-6 (1998-2 IRB 26).

³⁶ IRC Section 401(c)(2)(A).

³⁷ IRC Section 861(a)(3).

³⁸ IRC Section 408(a)(4), 408(b)(4).

³⁹ IRC Section 408(p)(2)(E)(i).

Year	Increased Deferral Limit
2002	\$ 7,000
2003	\$ 8,000
2004	\$ 9,000
2005	\$10,000
2006	\$10,000
2007	\$10,500
2008 and thereafter	Adjusted for inflation

The elective SIMPLE deferral limit increase for cost-of-living adjustments (COLAs) in increments of \$500 after 2006.⁴⁰

Catch-Up Elective Contributions

If a participant in a SIMPLE will attain age 50 by the end of the taxable year, he or she may make an additional elective deferral up to an applicable dollar limit. This catch-up amount is in addition to the normal deferral limit for the applicable year. The maximum amount of a catch-up contribution is the lesser of the participant's compensation for the year or the applicable dollar amount. The applicable dollar amounts are as follows:⁴¹

Year	Catch-Up Amount
2002	\$ 500
2003	\$1,000
2004	\$1,500
2005	\$2,000
2006	\$2,500
2007	\$2,500
2008 and thereafter	Indexed for inflation

The elective SIMPLE catch-up deferral limit increase for cost-of-living adjustments (COLAs) in increments of \$500 after 2006.⁴²

The rates for an employer's matching contribution, or nonelective contribution, have not changed. This means that under a SIMPLE IRA plan, a participant may defer 100 percent of compensation or \$10,500 (\$13,000 if age 50 or older), whichever is less, for 2007. The participant receives either a matching contribution of 3 percent of compensation (or less if permitted) based on his or her total compensation (no \$225,000

⁴⁰ IRC Section 408(p)(2)(E)(ii).

⁴¹ IRC Section 414(v).

⁴² IRC Section 414(v)(2)(C).

ceiling) or a nonelective contribution of 2 percent of compensation based on his or her total compensation (capped at \$225,000).

Example. Tabitha, age 55, participates in her employer's SIMPLE IRA plan. Her compensation for 2007 is \$600,000. Tabitha defers the maximum of \$13,000 (\$10,500 + \$2,500) for 2007. If her employer matches the amount of her deferrals at 3 percent of compensation, the matching contribution would be \$10,500 ($\$600,000 \times .03 = \$18,000$, but capped at \$13,000), the amount Tabitha deferred. Alternatively, if Tabitha's employer chooses the 2 percent nonelective contribution option, the nonelective contribution to Tabitha's account would be \$4,500 ($\$225,000$ compensation limit $\times .02$).

Termination of Election

An eligible employee must be permitted to terminate a salary-reduction agreement at any time. The termination request must be in writing and become effective as soon as practicable after receipt of the request by the employer or, if later, the date specified in the termination request.⁴³

Amendment of SIMPLE IRA

An amendment to a SIMPLE can be made effective only at the beginning of a calendar year and must conform to the content of the plan notice for the calendar year. Thus, an amendment that conforms to the plan notice may be made effective as of the beginning of that calendar year.

Employer Matching Contributions

An employer must make either a matching contribution or a nonelective contribution, as may be provided in the SIMPLE IRA. No other types of employer contributions are permitted.

An employer is generally required to match the employee's elective contribution on a dollar-for-dollar basis up to a limit of 3 percent of the employee's total compensation for the entire calendar year. The 3 percent limit may be reduced, but not below 1 percent, provided the percentage is not lowered for more than two calendar years out of the last five-year period ending with the calendar year in which the reduction is effective.

Years prior to the plan's effective date are treated as if the 3 percent contribution were made.

Employer Nonelective Contributions

In lieu of making a matching contribution, an employer may elect to make a nonelective contribution of 2 percent of compensation for each eligible employee, regardless of whether the employee elects to make salary-reduction contributions for the calendar year. Nonelective contributions, if selected, must be made on behalf of each eligible employee who has at least \$5,000 of compensation from the employer, whether or not the employee chose salary reduction.⁴⁴

The compensation cap of \$225,000 (the 2007 limit) applies to nonelective contributions. Thus, the maximum 2007 nonelective contribution amount or limit is \$4,500 ($\$225,000 \times .02$).⁴⁵

Plan Year

SIMPLE IRA plans must be maintained on a calendar-year basis. If the employer's business taxable year is not the calendar year, the deduction for the previous calendar year is postponed until the end of the fiscal year.

⁴³ IRC Section 408(p)(5)(B).

⁴⁴ IRC Section 408(p)(2)(B).

⁴⁵ IRC Section 408(p)(2)(B)(ii).

Example. The Holly Corporation maintains a SIMPLE plan and has a taxable year that ends on June 30, 2007. The contributions made in respect to 2007 will be deductible on Holly's federal corporate income tax return for its tax year ending June 30, 2008.

Deduction of Contributions

An employer may deduct contributions, including employees' elective contributions, for the employer's taxable year within which the calendar year for which the contributions were made ends.

A business may deduct contributions made into SIMPLE IRAs of eligible employees on its business tax return, where the contribution to the SIMPLE IRA is made *after* the business tax return is filed but *before* the due date of the return.⁴⁶ Contributions are treated as made for a taxable year if they are made on account of such taxable year and are made not later than the due date of the business tax return (including extensions).

Note. The employer, as is also true of employers making contributions under other salary-reduction plans, such as 401(k) plans, is deemed to have made the contribution on behalf of the employee who elected to reduce salary, and so the employer can take the same deduction that would have applied had the amount been paid to the employee as cash salary, rather than being directed to the SIMPLE IRA in accordance with the employee's instruction. Elective contributions are not included in an employee's gross income.

For the purpose of IRC Section 4972(d), a SIMPLE is treated as a qualified employer plan and is, therefore, subject to the penalty tax on nondeductible contributions. The employer is subject to a 10 percent penalty tax on any excess nondeductible contributions.⁴⁷

Contribution Due Dates

An employer must make matching contributions or nonelective contributions to the employee's SIMPLE IRA by the date that its tax return for the tax year is due (including extensions) for the purpose of claiming its deduction. For deduction purposes, employee elective contributions must be made to the employee's SIMPLE IRA no later than the thirtieth day of the month following the month in which the amounts would have been payable to the employee in cash (or the amount of earned income in the case of a self-employed individual is determined). Alternatively, if the elective contribution is made sooner, the contribution *must* be made on the earliest date the amount can reasonably be segregated from the employer's general assets.⁴⁸ Special rules may apply to partners in a partnership. See Chapter 20, "Deadlines for Depositing Employee Contributions and Loan Repayments."

An employer may deduct matching and nonelective contributions for its taxable year only if the contributions are made by the date (including extensions) the employer's tax return is due. A sole proprietor or a partner in a partnership must also have his or her personal income tax returns extended to the date contributions will be made or later.

Salary-reduction (elective) contributions must be made no later than the thirtieth day of the month following the month in which the amounts would have been payable to the employee in cash to be deductible by the employer, although they may have to be deposited sooner under Employee Retirement Income Security Act of 1974, as amended (ERISA).

⁴⁶ See Rev. Rul. 84-18 (1984-1 CB 88).

⁴⁷ IRC Section 4972(a), 4972(d)(1)(A)(iv).

⁴⁸ DOL Reg. Section 2510.3-102(b)(1).

Effect on Social Security Benefits

An employer's matching and nonelective contributions to a SIMPLE IRA are not subject to the Federal Insurance Contributions Act (FICA), which determines Social Security contributions, or Federal Unemployment Tax Act (FUTA). Elective contributions to a SIMPLE IRA are excludable from the employee's income and are not subject to federal income tax withholding, but they are subject to FICA, Medicare, railroad retirement, and federal unemployment taxes.

Example. In 2007, Tiger, age 60, was a participant in his employer's SIMPLE. His Form W-2, Wage and Tax Statement, compensation, before SIMPLE contributions, was \$41,600, or \$800 per week. Instead of taking all compensation in cash, Tiger elected to contribute 12.5 percent of his weekly pay (that is, \$100) to his SIMPLE IRA. For 2007, Tiger's salary-reduction contributions totaled \$5,200, which was less than the normal \$10,500-limit on such contributions for 2007. Under the plan, Tiger's employer is required to make dollar-for-dollar matching contributions to Tiger's SIMPLE IRA. The employer's matching contributions must equal Tiger's salary reductions but cannot be more than 3 percent of Tiger's annual compensation (before salary reduction). Thus, the employer's annual matching contribution to Tiger's SIMPLE IRA was limited to \$1,248 (that is, 3 percent of \$41,600).⁴⁹

If Tiger were self-employed (for example, not paid on Form W-2), only 92.35 percent of his self-employment income can be used; thus, his 3 percent contribution would be only \$1,152.53 ($\$41,600 \times .9235 \times .03$). As a self-employed individual, Tiger's *total* contribution, including the dollar-for-dollar matching contribution, would be \$6,352.53 (salary-reduction contributions of \$5,200 + \$1,152.53).

Example. The facts are the same as those in Example 1 except that Tiger's Form W-2 compensation for 2007 was \$300,000, and he chose to have \$13,000 contributed to his SIMPLE IRA. \$2,500 is treated as a catch-up contribution.

Tiger's salary-reduction contribution for the year, \$13,000 is the 2007 limit for individuals age 50 or older. Three percent of Tiger's annual compensation is \$9,000, which is more than the amount his employer was required to match (\$13,000), so Tiger's employer's matching contribution was \$9,000. The total contributions made on Tiger's behalf for the year are \$22,000 ($\$13,000 + \$9,000$) for 2007.⁵⁰

If Tiger were self-employed (that is, not paid on Form W-2), only 92.35 percent of his self-employment income could be used. Although Tiger could elect to defer \$13,000, his matching contribution may not exceed \$8,311.50 ($\$300,000 \times .9235 \times .03$). As a self-employed individual, Tiger's total contribution, including the dollar-for-dollar matching contribution, would be \$21,311.50 ($\$13,000 + \$8,311.50$). Had Tiger's self-employment income been \$469,229.38⁵¹ and had he contributed \$13,000 for 2007, he would receive the maximum matching contribution of \$13,000 ($\$469,229.38 \times .9235 \times .03$).

Example. The facts are the same as those in the first paragraph of Example 2 except that Tiger's employer chose to make nonelective contributions instead of matching contributions. Because an employer's nonelective contributions are limited to 2 percent of the first \$225,000 of the employee's compensation, Tiger's employer contributed \$4,500 to Tiger's SIMPLE IRA in 2007. The total contributions made on Tiger's behalf for the year were \$17,500 (Tiger's salary reductions of \$13,000 plus his employer's nonelective contribution of \$4,500).

⁴⁹ IRC Sections 408(p)(2), 1402(a)(12).

⁵⁰ IRC Sections 408(p)(2), 1402(a)(12).

⁵¹ $\$469,229.38$ equals $\$13,000$ divided by $.9235$ divided by $.03$.

Example. Tony, a self-employed individual with no other employees, has self-employment income of exactly \$4,331.35, resulting in net earnings from self-employment (NESE) of \$4,000. Tony's SIMPLE provides for a matching contribution (up to 3 percent of compensation). Tony's recharacterized compensation is \$3,880 (\$4,000 minus \$120 (\$4,000 × .03)). If Tony contributes \$4,000 and receives a \$120 matching contribution, the excess amount may be subject to a penalty tax. To the extent contributions under a SIMPLE are not deductible by the employer, the employer (including a self-employed individual who is treated as the employer) is subject to a 10 percent nondeductible contribution penalty tax under IRC Section 4972.⁵² Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans*, is used for this purpose.

Reporting Requirements

Employers maintaining a SIMPLE IRA plan do not generally have to file any of the Form 5500 series annual return/reports for employee benefit plans. However, an employer must report to the IRS on Form W-2 which employees are active participants in the SIMPLE IRA plan and the amount of the employee's salary-reduction (elective) contribution.⁵³

Excess Contributions

Excess SIMPLE IRA contributions are created if contributions are made in excess of the amounts permitted or if an employer does not qualify to establish or maintain a SIMPLE IRA plan.⁵⁴ An amount contributed on behalf of an employee that is in excess of an employee's benefit under the plan or an elective deferral in excess of the dollar amount (\$10,500/\$13,000, the 2007 limits) under IRC Section 402(g) is treated as an "excess amount."

The IRS has not issued formal guidance on excess contributions to a SIMPLE IRA. Form 5329 does not provide for such excesses to be reported on that form (nor does Form 5330 apply) because a SIMPLE IRA is not a traditional IRA, although it is an IRA (just like a SEP or a SARSEP). The Code does not appear to provide a remedy. An employer may be able to correct most failures under the IRS correction program (see Chapter 13).

Therefore, many financial organizations will not make a corrective distribution from a SIMPLE IRA. Instead, they consider any withdrawal an age-based distribution that is taxable when withdrawn and subject to the 25 percent penalty tax unless an exception applies. (See Chapter 16, "Rollovers and Portability.") These organizations suggest that the excess should either be left in the SIMPLE IRA (apparently they believe that the 6 percent excise tax under IRC Section 4973 is not an issue) or be withdrawn.

Excess contributions *timely* distributed from an IRA or SEP IRA are not subject to federal income tax (assuming no prior deduction was taken or the amount was not excluded from income). Thus, excess contributions distributed (with any gain thereon) before the due date of the individual's federal income tax return are not subject to the 10 percent tax upon early distribution even if the owner is under age 59½ at the time of distribution. Arguably, neither the 10 percent nor the 25 percent tax would apply when an excess contribution is timely corrected, inasmuch as the correcting distribution is not subject to taxation under IRC Section 408(d)(4). According to statements made by representatives of the IRS at the National Conference of the

⁵² IRC Section 4972(d)(1)(A)(iv), 4972(d)(2)(A).

⁵³ IRC Sections 408(p)(2), 1402(a)(12).

⁵⁴ IRC Sections 402(k), 408(p)(1).

American Society of Pension Actuaries (ASPA) in 2000, the 25 percent penalty does not apply if an employer adopts a 401(k) plan invalidating the qualified salary-reduction plan in a SIMPLE.⁵⁵

Treatment of Excesses

With one exception relating to excess deferrals under a SARSEP,⁵⁶ none of the guidance issued with respect to SIMPLE IRAs or to other types of excess contributions suggests how excess SIMPLE IRA contributions should be treated or specifies any correction method. Because excess contributions are not deductible, the employer is subject to a 10 percent penalty tax unless the excess is corrected.⁵⁷ An excess amount cannot be used by the employee as a traditional IRA contribution because such contributions must be made to a *traditional IRA*, a term that does not include a SIMPLE IRA.⁵⁸

The regular IRA excess contribution rules *do not* appear to apply to the employees, because a SIMPLE retirement account is “an individual retirement plan [as defined in Section 7701(a)(37)]” that must meet additional rules specified in IRC Section 408(p).⁵⁹ An *individual retirement plan* under IRC Section 7701(a)(37) is defined as an individual retirement account or individual retirement annuity under IRC Section 408(a) or 408(b), respectively. Thus, SIMPLE IRAs are not correctible under Code Sections 408(d)(4) and 408(d)(5).

The specific instructions for Form W-2 (2006), box 12, relating to 401(k) plan excesses, provide that the entire elective contribution is reported in box 12 (with code S). The instructions specifically state, “The excess is *not* reported in box 1” [emphasis added]. On the other hand, the instructions on the back of Form W-2 (2006) for completing box 12 state, with respect to code S, “Employee salary-reduction contributions under a section 408(p) SIMPLE (not included in box 1).” Arguably, excess contributions under a SIMPLE are to be reported in box 1 but should not be reflected in box 12. This approach seems to eliminate any employer penalty relating to nondeductible contributions by turning those amounts into nonallowable personal SIMPLE IRA contributions made by the employee.

Because traditional IRA contributions cannot be made to a SIMPLE IRA, in the authors’ opinion, the employee should remove the excess amount as soon as possible. This approach also seems to eliminate the distinction between excess employer contributions and excess employee contributions, but leaves open the issue of income tax withholding and FICA and FUTA taxes.

It is unclear whether including excess amounts on Form W-2 is an acceptable method of correcting excess contributions made to a SIMPLE IRA. Nonetheless, elective contributions that exceed the annual limit (\$10,500/\$13,000 for 2007) must be included on a taxpayer’s federal income tax return. The instructions to the employee on Copy C of Form W-2 state (for line 12): “Amounts in excess of the overall elective deferral limit must be included in income. See the ‘Wages, Salaries, Tips, etc.’ line instructions for Form 1040.” It is equally unclear whether an employer can avoid the nondeductible contribution penalty tax by including excess contributions amounts in box 1 of Form W-2. Until such time as additional guidance is issued, correction of excess contributions under the EPCRS (discussed below) is the only clearly sanctioned method of correction because the Code does not provide a remedy.

Excess traditional IRA contributions are subject to a 6 percent excise tax for each year that the excess remains in the IRA, but the tax cannot be more than 6 percent of the value of the IRA determined as of the

⁵⁵ Paul Schultz, Director of Employee Plans, Rulings and Agreements, and Richard J. Wickersham, Chief, Projects, Branch 2, at the IRS Q&As, ASPA National Conference (2000). The statements do not represent the official position of the IRS; they were neither reviewed nor approved by the IRS or the Department of the Treasury.

⁵⁶ IRS Notice 98-4, 1998-2 IRB 26.

⁵⁷ IRC Section 4972(d)(1)(A)(iv).

⁵⁸ IRC Section 408(p)(1)(B).

⁵⁹ IRC Section 408(p)(1).

end of the year.⁶⁰ Excess IRA contributions (with earnings) should be removed before April 15th of the tax year following the contribution of the excess amount. The individual reports the excise tax in Part II of Form 5329, and reports the 10 percent premature distribution penalty tax in Part I of Form 5329 unless an exception applies. Although the 6 percent penalty tax does not appear to apply to an excess SIMPLE IRA contribution according to the IRS, the IRS will eventually have to address this issue as it relates to Form 5329 (discussed above) and Form 1099-R distribution reporting codes. The instructions for Form 1099-R require that SIMPLE IRA distributions be reported in box 2a (taxable amount). Code S is generally entered in box 7 of Form 1099-R if the amount is distributed within 2 years and there is no known exception to the distribution penalty tax. The Form 1099-R instructions offer no clue as to the reporting codes that apply to the return of excess SIMPLE IRA contributions (adjusted for earnings) that are returned before or after the participant's tax filing deadline (including extensions). The requirement to report corrective distributions from nearly all types of plans are listed and extensively covered on page R-4 of the instructions to Form 1099-R; but the instructions contain no mention of excess contributions that are made to a SIMPLE IRA.

It could be argued that an excess contribution to a SIMPLE IRA should be treated in the same manner as an excess contribution to a SEP IRA. Under a SEP, contributions in excess of 25 percent of an individual's taxable compensation are includable in income and reported by the employer on Form W-2 as wages.⁶¹ No comparable provision applies in the case of a SIMPLE, nor does the 25 percent of compensation limit apply. Excess salary reduction contributions under a SARSEP are subject to special notification and timing rules, which in some cases treat the amount as an excess only after the notification is provided to the employee. In other cases, the entire arrangement is invalidated if no notification is provided. No notification requirements are applicable to excesses under a SIMPLE (other than including the amount in box 1).

Note. An employer cannot force a corrective distribution from any type of IRA-based plan, such as a SEP, SARSEP, or SIMPLE. It appears evident that the IRS is hesitant to address this issue and other issues relating to the proper administration of the tax laws relating to distributions and the correction of excess contributions.

Note. IRC Section 402(k) provides for excess contributions to be included in the participant's income, and IRC Section 404(m) does not provide for a carryforward of nondeductible employer amounts contributed to a SIMPLE IRA, whereas excesses under a SEP can be carried forward.⁶²

Although no Code remedy exists, it seems that the safest course of action (other than correction under the EPCRS) would be for the employer to direct a distribution to the participant (adjusted for earnings). For risk-management purposes, the trustee or custodian will likely request authorizing signatures from both the employer and participant.

EPCRS Correction

An amount contributed under a SIMPLE IRA on behalf of an employee that is in excess of an employee's benefit under the plan or an elective deferral in excess of the dollar amount (\$10,500/\$13,000 for 2007) under IRC Section 402(g) is treated as an "excess amount" under the IRS's EPCRS program. The EPCRS program provides for two possible correction procedures to correct excess amounts, and another for *de minimis* excess amounts.

⁶⁰ IRC Section 4973(a).

⁶¹ IRC Section 402(h).

⁶² See IRC Section 404(h)(1)(C).

1. Distribution of Excess Amounts. If an excess amount is attributable to elective deferrals, the plan sponsor may effect distribution of the excess amount, adjusted for earnings through the date of correction, to the affected participant. The amount distributed to the affected participant is includible in gross income in the year of distribution. The distribution is reported on Form 1099-R for the year of distribution with respect to each participant receiving the distribution. In addition, the plan sponsor must inform affected participants that the distribution of an excess amount is not eligible for favorable tax treatment accorded to distributions from a SIMPLE IRA plan (and, specifically, is not eligible for tax-free rollover). If the excess amount is attributable to employer contributions, the plan sponsor may effect distribution of the employer excess amount, adjusted for earnings through the date of correction, to the plan sponsor. The amount distributed to the plan sponsor is not includible in the gross income of the affected participant. The plan sponsor is not entitled to a deduction for such employer excess amount. The distribution is reported on Form 1099-R issued to the participant indicating the taxable amount as zero.⁶³ Self-correction under this method is generally available. [Rev. Proc. 2006-27, §9, 2006-22 I.R.B. 945]

Note. It may be difficult for a plan sponsor to utilize this method unless the trustee/custodian and the employee participant or participants all agree. A recalcitrant employee's SIMPLE IRA could face possible disqualification and lose its tax-exempt status.

2. Retention of Excess Amounts. If an excess amount is retained in the plan, a special compliance fee of 10 percent of the retained amount (excluding earnings) will generally apply. This is in addition to the \$250 submission compliance fee. If the error was egregious, additional special fees apply.⁶⁴ The plan sponsor is not entitled to a deduction for an excess amount retained in the SEP or SIMPLE IRA plan. In the case of an excess amount retained in a SEP that is attributable to a Section 415 failure, the excess amount, adjusted for earnings through the date of correction, must reduce affected participants' applicable Section 415 limit for the year following the year of correction (or for the year of correction if the plan sponsor so chooses), and subsequent years, until the excess is eliminated.

3. De minimis Excess Amounts. If the total excess amount in a SIMPLE IRA plan, whether attributable to elective deferrals or employer contributions, is \$100 or less, the plan sponsor is not required to distribute the excess amount and the special 10 percent compliance fee described in item 2 does not apply.⁶⁵

Deduction Carryforward

IRC Section 404(m) does not permit an employer to carry forward nondeductible amounts contributed to a SIMPLE IRA (whereas excesses under a SEP can be carried forward).⁶⁶

Time Requirements for Contribution Elections and Notices

Certain time requirements for employee elections and employer notices must be observed for SIMPLE IRAs, as follows:

Employee Elections

During the 60-day period before the beginning of a plan year and during the 60-day period before the employee is eligible to participate (the enrollment period), the employee may choose to contribute either a

⁶³ Rev. Proc. 2006-27, Section 6.10(5), 2006-22 IRB 945.

⁶⁴ Rev. Proc. 2006-27, Sections 12.05, 12.06, 2006-22 IRB 945.

⁶⁵ Rev. Proc. 2006-27, Section 12.05(c), 2006-22 IRB 945.

⁶⁶ See IRC Section 404(h)(1)(C).

percentage of compensation or a specific dollar amount, or an alternative that the employer prescribes concerning the form of election.

Enrollment Period

The election period is the 60-day period before the beginning of any year and the 60-day period before the employee first becomes eligible to participate. In general, the 60-day period is the statutory period during which an eligible employee may elect to participate or modify a previous election amount.⁶⁷ An employer may allow additional periods for making and changing elections or even lengthen the 60-day enrollment period. Thus, for a calendar year, an eligible employee may make or modify a salary-reduction election during the 60-day period immediately preceding January 1 of that year. For the year in which the employee becomes eligible to make salary-reduction contributions, however, the period during which the employee may make or modify the election is a 60-day period that *includes either the date the employee becomes eligible or the day before*.

The interpretation given the statute allows the 60-day period to include *at a minimum* either:⁶⁸

- The date of eligibility, in which case modifications could be made during the election period while the employee is a participant; or
- The day before an employee becomes eligible, in which case a modification could only be made before participation, unless the plan provides additional election periods.

Election Modification and Cancellation

An employee who commences participation during the election period may cancel or modify a previous election. Any such change is prospective and should be implemented by the employer as soon as is administratively feasible (or, if later, on the date specified by the employee in the salary-reduction agreement).

Example. On November 1, 2007, Tin Company decides to establish its first retirement plan. It adopts a SIMPLE IRA with no service or compensation requirements for its 40 employees. The plan is duly adopted and effective on January 1, 2008. Tin's employees are given a summary description, a model notification to eligible employees, and a model salary-reduction agreement on November 1, 2007. The 60-day period starts on November 2 and ends on December 31, 2007.

Here, the 60-day period includes the day before (December 31) the date the employee becomes eligible. Although contributions can be discontinued at any time, no modifications are permitted after the 60-day election period unless the plan provides for additional opportunities to modify (or make) an election to defer compensation.

Example. In May 2008, Tin Company decides to adopt its first retirement plan. It adopts a SIMPLE IRA with no compensation or service requirements covering its 60 employees. The plan is duly adopted on May 25 but states an effective date of June 1, 2008.

Employees are given a summary description, a model notification to eligible employees, and a model salary-reduction agreement on June 3. The 60-day period starts on June 3. The summary description and other notices must generally be given before the employees' 60-day election period. In this case, however, salary-reduction contributions may start as soon as administratively feasible, but no earlier than June 3, the day of

⁶⁷ IRC Section 408(p)(5)(C).

⁶⁸ Notice 98-4, Q&A E-1 (1998-2 IRB 26).

notification and delivery of the summary description (see the discussion entitled “Special Rule” that follows). The plan may provide for salary deferrals to start at some later date during the year. In this example, the 60-day period includes the date the employees became eligible (June 3). The employees may make or modify an election during the 60-day period that ends on August 2, 2008.

Example. Wick Company establishes a SIMPLE IRA plan effective as of July 1, 2008. Each eligible employee becomes eligible to make salary-reduction contributions on that date. The 60-day period must begin no later than July 1, 2008. Alternatively, it cannot end before June 30, 2008.

Special Rule

In the case of an employee who becomes an eligible employee other than at the beginning of a calendar year because (1) the plan does not impose a prior-year-compensation requirement, (2) the employee satisfied the plan’s prior-year-compensation requirement during a prior period of employment with the employer, or (3) the plan is effective after the beginning of a calendar year, the eligible employee must be permitted to make or modify a salary-reduction election during the 60-day period that *begins on* the day notice of the election is provided to the employee and that includes the day the employee becomes an eligible employee or the day before. In this case, the salary-reduction election will become effective as soon as practical after receipt of notification by the employee (or, if later, on the date specified by the employee in the salary-reduction agreement), but any election made by the employee may be modified prospectively at any time during the 60-day period.⁶⁹ An employee election that is timely made cannot be restricted by the employer except to keep the contribution amount within the legal limit for salary-reduction contributions.

Amendment

Once notices are given to the employee, the employer cannot amend the plan to change the type of contribution it chose to make. Any such amendment is not effective until the beginning of the following year. If the plan is terminated, the employer must make the contributions it specified or lose the deduction for its contributions. State law may also require that the employer make its agreed-to contribution.

Termination

Although SIMPLE IRA plans are established with the intention of being on-going, the time may come when a SIMPLE IRA plan no longer suits the business’s purposes. In a joint IRS/DOL (Department of Labor) publication, the IRS and the DOL state that to “terminate a SIMPLE IRA plan, notify the financial institution that you will not make a contribution for the next calendar year and that you want to terminate the contract or agreement. You must also notify your employees that the SIMPLE IRA plan will be discontinued. You do not need to give any notice to the IRS that the SIMPLE IRA plan has been terminated.” No further guidance is provided.⁷⁰

Employer Notices

Before the beginning of the employee’s 60-day election period, each employee must be notified by the employer of the employee’s opportunity to make, modify, or terminate a salary-reduction election under a SIMPLE IRA plan and the employer’s election to make reduced matching contributions or, alternatively, nonelective contributions. In this way, the employee who wishes to elect salary reduction will do so with the knowledge of how the employer will be determining its contribution. An employer must also furnish its employees with a summary description of the plan and other notifications before the beginning of the 60-day election

⁶⁹ Listing of Required Modifications and Information Package (LRM) for Savings Incentive Match Plan for Employees of Small Employers (SIMPLE IRA Plan) under IRC Section 408(p) (April 2005), item 6.

⁷⁰ IRS Pub. 4334, *Simple IRA Plans for Small Businesses*, p. 5 (Sept. 2004).

period. The IRS has provided model plan documents (which are not required to be filed with the IRS), including forms for meeting employer notification requirements, maintaining plan records, and proving that a SIMPLE IRA plan for employees was established.

The choice of form and the manner of its completion will indicate whether the employee participants are allowed to select the financial institutions for receiving their SIMPLE IRA contributions or whether the employer requires that all contributions under the plan be deposited at a designated financial institution.

If the employer uses a designated financial institution for contributions to the SIMPLE IRA plan, each employee must be notified in writing that his or her balance can be transferred without cost or penalty.

Taxation of Distributions

In general, all distributions from a SIMPLE IRA are taxable. If received before age 59½, the amount may also be subject to a 10 percent or 25 percent penalty.⁷¹ There are a number of exceptions to the early distribution penalty tax if the individual is under age 59½. (See Chapter 16.) If one of the exceptions to the application of the penalty tax applies (for example, for amounts paid after age 59½, after death, or as part of a series of substantially equal periodic payments), the exception will also apply to distributions within the two-year period, and the 25 percent penalty tax will not apply.

The two-year period begins on the first day on which contributions made by the individual's employer are deposited in the individual's SIMPLE IRA. It would appear that each SIMPLE IRA has its own two-year rule.

Withholding

The usual IRA rules apply to withholding.

IRS Reporting

The trustee or custodian is required to report distribution amounts to the IRS on Form 1099-R and provide a copy of the form to the owner of the SIMPLE IRA.

Rollovers and Transfers

The usual IRA rules apply to rollovers and trustee-to-trustee (or custodian-to-custodian) transfers. Rollovers must be completed within 60 days of distribution. The property that is rolled over must be the same property that was distributed.

With respect to SIMPLE IRAs, a tax-free rollover may be made from one SIMPLE IRA to another in similar fashion to rollovers between other IRAs of the same type (not more than once in any 12-month period).

A tax-free rollover may also be made from a SIMPLE IRA to a regular IRA or a Roth IRA, provided that the individual has participated in the SIMPLE IRA plan for the two-year period. Thus, a distribution from a SIMPLE IRA during the two-year period qualifies as a rollover contribution (and is not includable in gross income) only if the distribution is paid into another SIMPLE IRA and satisfies the other requirements for treatment as a rollover contribution.

Example. In 2007, Marbles Ltd. establishes a SIMPLE IRA plan covering two employees, Molly and George, both age 39. Both employees separate from service in 2008, having made no rollovers and having received no distributions. Molly rolls over the funds in her SIMPLE IRA account to a traditional IRA; George rolls over the funds in his account into a SIMPLE IRA maintained by his new employer, the Diamond

⁷¹ IRC Sections 72(t), 408(d)(1), 408(p)(1).

Company. In both cases, rollovers are made within the two-year period. Molly's rollover is invalid because it was not made to a SIMPLE IRA. Thus, the rollover amount is a taxable distribution.

In addition, Molly is liable for the 25 percent penalty tax. Furthermore, the amount she rolled over to her traditional IRA may be an excess contribution, if the annual limit of \$4,000 plus catch-up contributions for 2007 is exceeded. George's rollover is valid, so there are no tax consequences. Even if Diamond Company did not offer a SIMPLE IRA, George could have rolled over his funds into Marble Ltd.'s SIMPLE IRA into a SIMPLE IRA that he could establish.

Distributions made after 2001 from an individual's SIMPLE IRA (after the two-year period applicable to SIMPLE IRAs has expired) may be rolled over into a qualified plan or annuity, traditional IRA, 403(b) annuity or custodial account plan, or governmental 457(b) plan. This rule applies to all amounts in a SIMPLE IRA. This rule does not apply to any amounts in a Roth IRA or a Coverdell education savings account.⁷² Rollovers and transfers are more fully discussed in Chapter 16.

Subject to the "one rollover per 12-month period" rules, an individual may receive a distribution and roll over or transfer all or a portion of the amount received into another SIMPLE IRA, or after the two-year rule is satisfied, a traditional or Roth IRA. In the case of property, the identical property must be rolled over. Any amount not rolled over (or transferred) is subject to federal income tax, and if the employee is under age 59½, a 10 percent or 25 percent early distribution penalty tax may apply.

ERISA Requirements

For purposes of Section 404(c) of the ERISA, a participant or beneficiary in a SIMPLE IRA will be treated as exercising control over the assets in his or her account on the earliest of one of the following:

- An affirmative election among investment options with respect to the initial investment of any contribution
- A rollover to any other SIMPLE retirement account or IRA
- One year after the SIMPLE retirement account is established

Bonding

In most cases, an employer that handles funds or other property that belongs to an ERISA plan (including a SEP or SIMPLE) is required to be bonded. The basic standard is determined by the possibility of risk of loss in each situation; thus, it is based upon the facts and circumstances in each situation. The amount of such bond, which is determined at the beginning of each year, cannot be less than 10 percent of the amount of funds handled. The minimum bond is \$1,000. However, contributions made by withholding from an employee's salary are not considered funds or other property of a SIMPLE (or SEP) for purposes of the bonding provisions so long as they are retained in and not segregated in any way from the general assets of the withholding employer. Because employer contributions are made into SIMPLE IRAs established by each employee (which are outside the control of an employer once made), bonding would not generally apply.⁷³

Summary Description

The trustee of the SIMPLE is required to provide to an employer, each year, a summary description containing the following information:

⁷² IRC Section 408(d)(3)(A), 408(d)(3)(D)(i).

⁷³ ERISA Sections 404(c), 412; DOL Reg. Sections 2510.3-3, 2550.412-5.

- Name and address of the employer and the trustee
- Eligibility requirements for participation
- Benefits provided
- Time and method of making employee elections
- Procedures for and effects of withdrawals (including rollovers) from the arrangement

In general, an employer must notify each employee, immediately before the period for which an employee election may be made, of his or her opportunity to make the election and include a copy of the above description if received from the trustee. This is the only report required of an employer that maintains a SIMPLE.⁷⁴

In addition, a trustee must give each participant, within 31 days after the end of each calendar year, a statement showing the account activity during the year and the account balance at the close of the year. The trustee is also required to make reports to the IRS on Form 5498.⁷⁵

Elective Contributions

Elective contributions to an employee's SIMPLE IRA must be made no later than the thirtieth day of the month following the month in which the amounts would have been distributed to the employee in cash but for the election or, if sooner, the earliest date the amounts can reasonably be segregated from the employer's general assets.⁷⁶ The 30-day rule is not a safe harbor.

Retirement Planning Advice

EGTRRA clarifies that retirement planning advice provided to employees (and their spouses) after 2001 on an individual basis is a nontaxable fringe benefit to the extent such advice is made available on substantially equivalent terms to all employees.⁷⁷

Tax Credits

Tax Credit for Employers

A small business that adopts a new SIMPLE can generally claim an income tax credit for 50 percent of the first \$1,000 in administrative and retirement-education expenses for each of the first three years of the plan. The tax credit for employers is more fully discussed in Chapter 1, "Introduction."

Tax Credit for Employees

For the 5 taxable years beginning after 2001 (that is, 2002 through 2006), certain individuals may receive a nonrefundable low-income taxpayer contribution credit for a percentage of their contributions. The credit is based on a sliding-scale percentage of up to \$2,000 contributed to a SIMPLE IRA. The credit is in addition to any other tax benefit (for example, possible tax deduction) that the contribution gives the taxpayer.⁷⁸ The tax credit for employees is more fully discussed in Chapter 2, "Simplified Employee Pension Plans—SEP and SARSEP."

⁷⁴ IRC Section 408(1)(2)(A)B(C).

⁷⁵ IRC Section 408(i), as amended by Tax Reform Act of 1997 (TRA Section 1601(d)(1)(A)).

⁷⁶ DOL Reg. Section 2510.3-102.

⁷⁷ IRC Section 132(a)(7), 132(m)(1).

⁷⁸ IRC Section 25B(a), 25B(b).

SIMPLE IRA Advantages and Disadvantages

The advantages of SIMPLE IRAs are that they:

- Are easy to establish.
- Are easy to understand and communicate to employees.
- Have limited fiduciary liability.
- Are subject to minimal reporting requirements.
- Are cost-effective.
- Have no nondiscrimination testing.
- Are subject to no minimum participation requirements.
- Are vested 100 percent and immediately.

SIMPLE IRAs also have a number of disadvantages, as follows:

- Annual employer contribution is required.
- The maximum salary-reduction (elective) contribution is limited to \$10,500 plus catch-up contributions (\$2,500 maximum) for 2007.
- Compensation for nonelective contributions is limited to \$225,000 for 2007.
- Employer contributions are limited to 3 percent of each participant's compensation.
- The employer may not generally maintain any other type of retirement plan.
- A 25 percent penalty may apply to distributions removed within the first two years from the date the SIMPLE was established by the employer.
- Life insurance may not be held in a SIMPLE IRA.
- Loans are not permitted.
- Leased employees must be covered.
- Creditors of employees may be able to gain access to SIMPLE IRA assets.
- Employees are not required to be employed on the last day of the year.
- No lump-sum distribution or five-year averaging of capital gains is allowed.
- Unlike for qualified plans, there is no exception from the early distribution tax for distributions (1) after separation from service after attaining age 55, (2) for deductible medical expenses, or (3) to alternate payees under a qualified domestic relations order. On the other hand, the early distribution tax exception for periodic payments applies whether or not the individual has separated from service, whereas for qualified plans that exception applies only for payments beginning after the employee's separation from service.

401(k) SIMPLE Plans

A 401(k) SIMPLE plan is a qualified 401(k) plan that adopts some of the SIMPLE rules to satisfy annual nondiscrimination tests. SIMPLE is the acronym for savings incentive match plan for employees.

A 401(k) SIMPLE plan maintained by an eligible employer is treated as satisfying the participation and discrimination standards of the IRC provided the arrangement satisfies special rules relating to contributions and vesting and is the only plan of the employer.⁷⁹

Although the 401(k) SIMPLE rules are in IRC Section 401(k)(11), subparagraph (D) of that section states that, "any term used in this paragraph which is also used in section 408(p) shall have the meaning given such term by such section." Thus, some of the 401(k) SIMPLE rules are borrowed from and are the same as the rules for SIMPLE IRAs previously discussed in this chapter.

The 401(k) SIMPLE rules apply to plan years beginning after December 31, 1996.⁸⁰

Because of the limits, restrictions, and complexities of a 401(k) SIMPLE plan, some commentators believe it unlikely that many employers will establish SIMPLEs in 401(k) form. In the authors' opinion, other types of 401(k) plans (for example, safe harbor 401(k) plans) are more suitable for most employers.

Plan Year

The plan year of a plan containing 401(k) SIMPLE provisions must be the calendar year. Thus, an employer maintaining a 401(k) plan on a fiscal-year basis must convert the plan to a calendar year in order to adopt 401(k) SIMPLE provisions.⁸¹

Qualification Requirements

Nearly all of the qualification requirements of the IRC continue to apply to a plan that adopts 401(k) SIMPLE provisions, including the following:

1. The contribution limits of IRC Section 415 (100 percent/\$45,000 plus catch-up contributions for 2007) must be met.
2. The compensation limit (\$225,000 for 2007) of IRC Section 401(a)(17) must be met.
3. The plan as amended must operate in accordance with its terms.

In addition, all other requirements applicable to 401(k) plans continue to apply, including the following:

4. The distribution restrictions of IRC Section 401(k)(2)(B), which generally prohibit elective contributions from being distributed before a participant's severance from employment, attainment of age 59½, death, disability, or hardship
5. The general prohibition set forth in IRC Section 401(k)(4)(B) against state and local governments' maintaining a 401(k) plan

Vesting

All contributions (adjusted for gains and losses) made under a 401(k) SIMPLE plan must be fully vested (non-forfeitable) at all times.⁸² Contributions not made under the SIMPLE rules in other years may continue under existing or other qualified plan vesting rules.

⁷⁹ IRC Section 401(k)(11)(A).

⁸⁰ IRC Section 401(k)(11), 401(m).

⁸¹ IRC Section 401(k)(11)(D)(i); Rev. Proc. 97-9, Section 2.04 (1997-1 CB 624); Rev. Proc. 87-27 (1987-1 CB 769), regarding automatic approval of certain changes in accounting periods for qualified plans and trusts.

⁸² IRC Section 401(k)(11)(A)(iii).

Employer Eligibility

Generally, a 401(k) SIMPLE plan may be established only by an employer that had no more than 100 employees (the 100-employee limit) who earned \$5,000 or more in compensation during the preceding calendar year.⁸³ There is a two-year grace period if an eligible employer ceases to be eligible in a subsequent year. For purposes of the 100-employee limit, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE.

Note. The 100-employee limit for a 401(k) SIMPLE plan is the same as the 100-employee limit for a SIMPLE IRA plan.

A tax-exempt employer may maintain a 401(k) SIMPLE plan after 1996. A governmental entity (other than an Indian tribal government), on the other hand, may not maintain a SIMPLE in the form of a 401(k) plan. It should be noted, however, that the IRC does not expressly prohibit tax-exempt organizations or government employers from establishing a SEP plan or SIMPLE IRA plan.⁸⁴

An employer maintaining a 401(k) SIMPLE plan that fails to be an eligible employer may continue to maintain the plan for two years following the last year in which it was eligible.⁸⁵

Further, if the failure to satisfy the 100-employee limit is the result of an acquisition, disposition, or similar transaction involving the employer, the qualified plan transition rule for coverage if there is an acquisition or disposition replaces the two-year grace period; that is, the grace period runs through the end of the year following the acquisition or disposition.⁸⁶

Exclusive Plan Requirement

Like a SIMPLE IRA plan, a 401(k) SIMPLE plan must be the only *qualified plan* of the employer. If the employer maintains another qualified plan, that plan must be frozen or terminated.⁸⁷ It should also be noted that an employer may not maintain more than one SIMPLE plan.

The Technical Corrections Act of 1998 provides for a uniform grace period during which a 401(k) SIMPLE plan may be maintained following an acquisition, disposition, or other similar transaction that affects the employer's ability to meet the following requirements:

1. The 100-employee limit
2. The exclusive plan requirement
3. The plan coverage and eligibility rules

Practice Pointer: If an employer with a 401(k) SIMPLE plan fails to meet any of the above requirements because of an acquisition, disposition, or other similar transaction, the plan may be maintained for a transition period that begins on the date of the transaction and ends on the last day of the second calendar year following the calendar year in which the transaction occurs. For the grace period to apply, coverage under the plan may not be significantly changed during the transition period.

⁸³ IRC Sections 401(k)(11)(A), 401(k)(11)(D), 408(p)(2)(C)(i)(I).

⁸⁴ See IRC Section 401(k)(4)(B)(ii); G.S. Lesser, *457 Answer Book*, 5th Ed., Qs 2:15 and 2:16 (New York: Aspen Publishers, 2007).

⁸⁵ Rev. Proc. 97-9, Appendix Section 1.2(a) (1997-1 CB 624).

⁸⁶ IRC Section 408(p)(2)(C)(i)(II), 410(b)(6)(C).

⁸⁷ IRC Section 401(k)(11)(A)(ii), 401(k)(11)(C).

For a 401(k) SIMPLE plan to be maintained during the transition period, it must meet the above requirements following the transaction as if the employer maintaining the plan had remained a separate employer.

Employee Eligibility

Employee eligibility for a 401(k) SIMPLE plan is based on qualified plan rules, under which, for example, an employee may be eligible after the completion of one year of service (generally, 1,000 hours) and attainment of age 21. Any employee who is eligible to make elective deferrals under the regular 401(k) plan rules is eligible to participate in the 401(k) SIMPLE plan. As is the case with a SIMPLE IRA plan, collectively bargained employees, nonresident alien employees, and so on, may be excluded from participating in a 401(k) SIMPLE plan.⁸⁸

Contributions for Household Workers

An employer may make a contribution on behalf of each domestic (and similar) worker other than the employer or a member of the employer's family. The employer's contributions, however, do not qualify for a deduction, because the contributions are not made in connection with a *trade or business*. For taxable years beginning after 2001, the 10 percent excise tax on nondeductible contributions does not apply to 401(k) SIMPLE or SIMPLE IRA plan contributions, simply because the contributions are not a trade or business expense.⁸⁹

Note. IRC Section 4972(c)(6) is intended to apply only to employers that have paid and continue to pay all applicable employment taxes.⁹⁰

Participant Contribution Aggregation

An employee may participate in a SIMPLE plan of one employer and in a SIMPLE plan or qualified plan of another employer without violating the exclusive plan requirement, provided the employers are unrelated. In such a case, the total elective deferrals that can be made under more than one plan generally may not exceed \$15,500, plus catch-up contributions for 2007.⁹¹

Contributions made under a 457 plan do not violate the only-plan-of-the-employer rule because such a plan is not a qualified plan, and is not treated as a qualified plan for the purpose of denying SIMPLE contributions. The dollar limit under an eligible 457(b) plan (generally \$15,500 for 2007) is not reduced by the amount of elective employer contributions deferred by the employee under the 401(k) SIMPLE plan for years after 2001.⁹²

Caution: *An employer can not have more than one SIMPLE-IRA plan. If contributions are to be made to SIMPLE IRAs at more than one financial institution, be certain that (all but one) will accept contributions without requiring the employer to adopt an "additional" SIMPLE IRA plan. Using the IRS model form for this purpose, even as an accommodation to the trustee or custodian, could result in disqualification of all of the employer's SIMPLE-IRA plans.*

⁸⁸ Rev Proc 97-9, Appendix Section 2.2 (1997-1 CB 624).

⁸⁹ IRC Section 4972(c)(6).

⁹⁰ EGTRRA Section 637; see HR Rep No. 107-51, pt 1 (2001).

⁹¹ IRC Section 402(g)(1), 402(g)(3)(D).

⁹² IRC Section 457(c)(2)(B)(i).

Compensation

The SIMPLE IRA plan definition of compensation is used for a 401(k) SIMPLE plan.

Contributions

Under a qualified plan containing 401(k) SIMPLE provisions, each employee may elect to make salary-reduction contributions of up to \$10,500 (\$13,000 with a catch-up contribution if age 50 or over) for 2007. Each year, the employer must make either a matching contribution or a nonelective contribution, as follows:

1. *Matching contribution.* Each year, the employer makes a matching contribution to the plan on behalf of each employee who makes a salary-reduction election. The amount of the matching contribution is equal to the employee's salary-reduction contribution (up to \$10,500/\$13,000), up to a limit of 3 percent of the employee's compensation for the full calendar year.
2. *Nonelective contribution.* For any year, instead of a matching contribution, the employer may choose to make a nonelective contribution of 2 percent of compensation (up to \$4,500 for 2007⁹³) for the full calendar year for each eligible employee who received at least \$5,000 (or less if elected) of compensation from the employer for the year.

An employer does not have the option under a 401(k) SIMPLE plan of reducing the matching contribution to less than 3 percent of an employee's compensation.⁹⁴ Such an option does exist for a SIMPLE IRA plan.

No other types of contributions are permitted.⁹⁵

Contribution Limits

The elective deferral limit for a 401(k) SIMPLE plan will increase from \$7,000 for 2003, as follows:

Year	Increased Deferral Limit
2003	\$ 8,000
2004	\$ 9,000
2005	\$10,000
2006	\$10,000
2007	\$10,500
2008	As indexed

After 2005, the elective 401(k) SIMPLE plan deferral limit will be increased for COLAs in increments of \$500.⁹⁶

In addition, if a participant in a 401(k) SIMPLE plan reaches age 50 by the end of the calendar year, he or she may make an additional elective deferral. The amount of this catch-up contribution is in addition to the normal deferral limit for the applicable year.

⁹³ \$225,000 (the maximum compensation limit for 2007) times .03 = \$4,500.

⁹⁴ IRC Section 401(k)(11)(B).

⁹⁵ IRC Sections 401(k)(11)(B), 401(k)(11)(B)(i)(III).

⁹⁶ IRC Section 408(p)(2)(A)(ii), 408(p)(2)(E).

The maximum amount of a catch-up contribution is the lesser of the participant's compensation for the year or the applicable dollar amount.⁹⁷ The applicable dollar amounts are as follows:

Year	Normal Limit	Applicable Catch-Up	Total Deferral
1997–2000	\$ 6,000	n/a	\$ 6,000
2001	\$ 6,500	n/a	\$ 6,500
2002	\$ 7,000	\$ 500	\$ 7,500
2003	\$ 8,000	\$1,000	\$ 9,000
2004	\$ 9,000	\$1,500	\$10,500
2005	\$10,000	\$2,000	\$12,000
2006	\$10,000	\$2,500	\$12,500
2007	\$10,500	\$2,500	\$13,000
2008	As indexed	As indexed	

After 2006, the catch-up elective 401(k) SIMPLE plan deferral limit was increased for COLAs in increments of \$500.⁹⁸

This means that a 401(k) SIMPLE plan participant who is age 50 or over by the last day of participant's taxable year (generally December 31) may defer 100 percent of compensation or \$13,000, whichever is less, for 2007. The employer may choose to make a 3 percent of compensation matching contribution based on the participant's total compensation or a 2 percent of compensation nonelective contribution based on the participant's total compensation. In both cases, compensation is capped at \$225,000.

Contributions to a 401(k) SIMPLE plan may not be reduced or increased by taking into account Social Security or other similar contributions.⁹⁹

The 100 percent of taxable compensation limit under IRC Section 415 (25 percent before 2003) applies to a 401(k) SIMPLE plan, although it does not apply to a SIMPLE IRA plan. Furthermore, the employer's deduction for contributions made to a 401(k) SIMPLE, including salary-reduction contributions, is not limited to 25 percent of the participant's aggregate compensation under IRC Section 404.¹⁰⁰

A salary-reduction election may not apply to compensation that an employee received, or had a right to immediately receive, before execution of the salary-reduction agreement or election. A participant in a 401(k) SIMPLE plan may discontinue contributions at any time during the calendar year.¹⁰¹

Discrimination Testing

For a year in which the SIMPLE rules are used to satisfy nondiscrimination standards, the nondiscrimination tests applicable to elective deferrals and matching contributions will be satisfied provided all SIMPLE

⁹⁷ IRC Section 414(v).

⁹⁸ IRC Section 414(v)(2)(c).

⁹⁹ IRC Section 401(k)(3)(B).

¹⁰⁰ IRC Section 404(a)(3)(A)(i), 404(a)(3)(A)(ii), 404(n).

¹⁰¹ IRC Section 408(p)(5)(B).

contributions are fully vested, and the employer makes the required contribution.¹⁰² Thus, the plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test applicable to matching contributions unless the employer fails to make SIMPLE contributions. A 401(k) plan that includes 401(k) SIMPLE provisions is not treated as top heavy under IRC Section 416.

Form W-2 Reporting

Salary-reduction contributions to a 401(k) SIMPLE plan must be reported on Form W-2, Wage and Tax Statement.¹⁰³ On Form W-2, a code must be used to designate amounts reported in box 12. Code D is used to report salary-reduction contributions made under a 401(k) SIMPLE plan. Like other types of contributions made to qualified plans, matching and nonelective (that is, employer) contributions are not required to be reported on Form W-2.¹⁰⁴

Contribution Deduction

Within limits, contributions are deductible by the employer for its business taxable year that includes or coincides with the last day of the plan year, which is always December 31 in the case of a SIMPLE. Thus, if a taxpayer with a fiscal tax year ending June 30 adopts a 401(k) SIMPLE plan for 2007, the taxpayer may claim a deduction for 2007 contributions on its business tax return for the period ending June 30, 2008.¹⁰⁵

Practice Pointer: For deduction purposes only, employer matching or nonelective contributions to a 401(k) SIMPLE plan must be made on or before the date the employer's federal income tax return is due (including extensions).¹⁰⁶

Elective contributions are assets of a 401(k) SIMPLE plan. The employer must promptly transmit any employee salary-reduction contributions to the plan's trust on the earliest date such contributions can reasonably be segregated from the employer's general assets, but not later than the fifteenth business day of the month following the month in which the contributions were withheld or received by the employer.¹⁰⁷ The 15-day rule, it should be noted, is not a safe harbor. For deduction purposes, however, the employer must deposit (remit to trustee or custodian) elective contributions not later than the 30-day period following the last month with respect to which the contributions are to be made.¹⁰⁸

Distributions

All 401(k) plans, including those that are SIMPLEs, must limit in-service distributions of elective contributions.¹⁰⁹ Except for loans, distributions to participants and beneficiaries of amounts attributable to elective deferrals may not be made to participants and beneficiaries earlier than upon any of the following:

¹⁰² IRC Section 401(k)(11)(A), 401(k)(11)(B).

¹⁰³ Notice 98-4, Q&A I-1 (1998-2 IRB 26).

¹⁰⁴ Notice 98-4, Q&A I-1 (1998-2 IRB 26).

¹⁰⁵ IRC Section 404(a)(3).

¹⁰⁶ IRC Section 404(a)(6).

¹⁰⁷ DOL Reg. Section 2510.3-102; see, too, chapter 20.

¹⁰⁸ IRC Section 408(p)(5)(A)(i).

¹⁰⁹ IRC Section 401(k)(2)(B), 408(k)(10); Rev Proc 97-9, Appendix Section 2.06 (1997-1 CB 624).

1. Death
2. Disability
3. Severance from employment (before 2002, separation from service)
4. For distributions made before 2002, the disposition of 85 percent or more of the employer's assets to an unrelated corporation, provided the employee continues employment with the purchaser
5. The disposition of the employer's subsidiary to an unrelated entity (or individual), provided the employee continues employment with the subsidiary
6. The employee's hardship
7. The termination of the plan, provided a lump sum distribution is received

Separation from service occurred only upon a participant's discharge, retirement, resignation, or death. It did not occur if the employee continued on the same job for a different employer as a result of a consolidation, merger, liquidation, or some other corporate transaction.

Severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under the *same desk rule*, a participant's severance from employment does not necessarily result in a separation from service.¹¹⁰

Generally, distributions from a 401(k) SIMPLE plan are taxable as ordinary earned income and thus are subject to federal income tax withholding. The withholding rate is 20 percent.¹¹¹

Individuals born before 1936 may be able to use the special 10-year income averaging method of computing the tax on a qualifying lump-sum (nonperiodic) distribution. Five-year income averaging has been repealed for years after 1999.¹¹²

Hardship withdrawals from a 401(k) SIMPLE plan are permitted upon the request of a participant if (1) the participant has an "immediate and heavy financial need" and (2) other resources are not reasonably available to meet the need.

Withdrawals for medical expenses, tuition and related educational expenses, costs related to the purchase of a principal residence, and payments necessary to prevent eviction or foreclosure have all been deemed by the IRS to satisfy the immediate and heavy financial need requirement.¹¹³

Hardship withdrawals are taxable and may be subject to a 10 percent premature distribution penalty unless the participant is age 59½ or older.

Note. The period during which an employee is suspended from making elective contributions (and after-tax contributions) following a hardship distribution was reduced from 12 months to 6 months.¹¹⁴

The 25 percent penalty for distributions made within the first two years of the employee's participation in a SIMPLE IRA does not apply to a SIMPLE in the form of a 401(k) plan.¹¹⁵

Because IRA distribution rules do not apply to 401(k) SIMPLE plans, distributions may commence after age 70½ if the participant is employed at that time and is not a 5 percent owner.¹¹⁶

¹¹⁰ Rev Rul 79-336 (1979-2 CB 187).

¹¹¹ IRC Section 3405(b), 3405(e)(1); Treas. Reg. Section 35.3405-1.

¹¹² IRC Section 402(d), 402(e)(4)(D).

¹¹³ Treas. Reg. Section 1.401(k)-1(d)(2).

¹¹⁴ Treas. Reg. Section 1.401(k)-1(d)(2)(iv)(B).

¹¹⁵ IRC Section 72(t)(6).

¹¹⁶ IRC Section 401(a)(9)(C)(i), 401(a)(9)(C)(ii)(II).

Rollovers and Transfers

All the regular rollover rules apply to 401(k) SIMPLE plans. Thus, a participant who receives a distribution from a 401(k) SIMPLE plan may generally defer tax on the taxable amount received by rolling it over within 60 days of receipt to another qualified employer-sponsored plan or to an IRA. A SIMPLE IRA may not, however, be used to receive a rollover from a qualified plan, including a 401(k) SIMPLE plan.¹¹⁷ Rollovers and transfers are more fully discussed in Chapter 16.

Plan Correction Procedures

All the remedial correction programs offered by the IRS under the EPCRS, see Chapter 13, can be used for a 401(k) SIMPLE plan because it is a qualified plan under IRC Section 401(a).¹¹⁸

In the absence of well-established guidance, the position of the IRS regarding excess contributions to a SIMPLE 401(k) plan is, at best, unclear. Several possibilities exist, some of which offer solutions:

1. The plan becomes a traditional 401(k) plan and is taken out of the realm of a 401(k) SIMPLE plan. In the authors' opinion, this is an unlikely choice because of the information provided to the participant by the plan regarding the manner in which the plan would operate for that plan year.
2. The plan becomes a "bad" SIMPLE plan or a plan with a "bad" contribution allocation. Correction should be made under the EPCRS.
3. It may be possible to correct the excess contribution if plan contributions are the result of a mistake of fact.¹¹⁹ In the authors' opinion, this option is least likely; furthermore, the IRS has not included excess SIMPLE contributions among clear mistakes of fact.
4. It may be possible to correct the excess contribution (in accordance with plan provisions) if plan contributions are conditioned on their deductibility and the deduction for the contributions is subsequently denied.¹²⁰
5. In May 1999, the IRS informally agreed with propositions 2 and 4.¹²¹

Practice Pointer: Practitioners should proceed with caution when addressing excess contributions to a 401(k) SIMPLE plan and check for recent guidance provided by the IRS.

Tax Credits

As of 2002, a small business that adopts a new 401(k) SIMPLE plan may generally claim an income tax credit for 50 percent of the first \$1,000 in administrative and retirement-education expenses for each of the first three years of the plan. The credit is available only to employers that did not have more than 100 employees with compensation in excess of \$5,000 during the previous tax year. The employer must also have had at least one nonhighly compensated employee (NHCE). The credit is taken as a general business credit on the employer's business tax return. The other 50 percent of the expenses may be taken as a business deduction.

¹¹⁷ See SIMPLE IRA Listing of Required Modifications (LRM) and Information Package (March 2002).

¹¹⁸ Rev Proc 2003-44 (2003-25 IRB 1051).

¹¹⁹ ERISA Section 403(c)(2)(A).

¹²⁰ ERISA Section 403(c)(2)(C), IRC Section 4972(c)(2).

¹²¹ General Information Letter issued to Gary S. Lesser, May 18, 1999; see also Rev Rul 91-4 (1991-1 CB 57).

The expenses must be paid or incurred in taxable years beginning after 2001 and with respect to plans established after 2001.¹²²

Beginning after 2001, there is a low-income taxpayer credit that allows certain individuals to receive a nonrefundable tax credit for a percentage of their contributions to a 401(k) SIMPLE plan. The credit is based on a sliding-scale percentage of up to \$2,000 contributed to a traditional IRA or a Roth IRA, elective deferrals made to a SIMPLE, a SEP, a 401(k) plan, a 403(b) plan, or a 457(b) plan, and voluntary after-tax contributions to a qualified plan. The credit is in addition to any other tax benefit (that is, the potential tax deduction) that the contribution affords the taxpayer.¹²³ The credit is more fully discussed in Chapter 2.

Note: An employee who makes elective deferrals to a 401(k) plan, including a 401(k) SIMPLE plan, may be entitled to a contribution tax credit. See Chapter 2 for more information.

¹²² IRC Section 45E.

¹²³ IRC Section 25B(a)-25B(b).

Exhibit 3-1. SIMPLE IRA Checklist for 2007

Every year it is important that the requirements for operating a SIMPLE-IRA plan be reviewed. The following list is a "quick tool" to help keep a SIMPLE-IRA plan in compliance with many of the important tax rules. This list is not a complete description of all plan requirements, and should not be used as a substitute for a complete plan review.

	YES	NO
1. Does the business have <u>100 or fewer employees</u> ? <i>Businesses with more than 100 employees (including full-time, part-time, and seasonal employees) with individual earnings of at least \$5,000 yearly cannot establish a SIMPLE IRA plan.</i>	<input type="checkbox"/>	<input type="checkbox"/>
2. Is this SIMPLE IRA plan the business's <u>only retirement plan</u> ? <i>A business with a SIMPLE IRA plan generally cannot also sponsor any other retirement plan, such as a 401(k) plan.</i>	<input type="checkbox"/>	<input type="checkbox"/>
3. Have <u>eligible employees</u> been identified properly? <i>An eligible employee is one with compensation of at least \$5,000 per year in any 2 prior years, who is expected to earn at least \$5,000 this year.</i>	<input type="checkbox"/>	<input type="checkbox"/>
4. Is the business that the SIMPLE IRA plan covers the only business that the owner and/or his or her family members own? <i>Employees of other businesses the owner and/or his or her family members own may have to be considered when determining who is an eligible employee under this SIMPLE IRA plan.</i>	<input type="checkbox"/>	<input type="checkbox"/>
5. Were eligible employees notified of their right to elect salary reduction or modify a prior salary reduction agreement? <i>Each year, the employer must give its employees notice before November 2 of their right to participate in the retirement plan for the next year and to change a prior salary reduction agreement.</i>	<input type="checkbox"/>	<input type="checkbox"/>
6. Were employees given annual notice, before November 2 of each year, of plan provisions and employer contribution levels for the upcoming year? <i>Employees must be given a notice of the plan provisions and employer contribution levels, including any plan changes, at least 60 days prior to the start of the next calendar year.</i>	<input type="checkbox"/>	<input type="checkbox"/>
7. Are employees allowed to terminate their <u>salary reduction election</u> ? <i>An employee must be allowed, at any time, to stop making deferrals.</i>	<input type="checkbox"/>	<input type="checkbox"/>
8. Have employee deferrals been <u>deposited</u> on time? <i>An employer must deposit an employee's deferral in the IRA as soon as possible, but no later than 30 days following the month in which the employee would have otherwise received the money.</i>	<input type="checkbox"/>	<input type="checkbox"/>
9. Have <u>employer contributions</u> been <u>deposited</u> on time? <i>An employer has until the due date, including extensions, of its tax return to deposit matching contributions or nonelective contributions.</i>	<input type="checkbox"/>	<input type="checkbox"/>
10. Are employee deferrals to SIMPLE <u>limited</u> as required by law? <i>The deferral limit to a SIMPLE IRA is \$10,500 for 2007. Catch-up contributions of participants, aged 50 or over, are limited to an additional \$2,500 for 2007.</i>	<input type="checkbox"/>	<input type="checkbox"/>

If "No" was the response to any of the above questions, mistakes were made in the operation or administration of the SIMPLE-IRA plan. Many mistakes can be corrected easily, without penalty and without notifying the IRS (see Chapter 13).

Chapter 4

Qualified Plan in General

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If the qualification requirements set forth in the Internal Revenue Code (IRC or the Code) are satisfied, a qualified plan may offer the employer (and participants) significant advantages. Small businesses will often find that a properly designed qualified plan will provide significant benefits for the business owners at a reasonable cost of benefits for the rank and file employees.

Qualified Plan Advantages

Assuming the qualification requirements set forth in the Internal Revenue Code are satisfied, a qualified plan may offer the following advantages:

1. Contributions are deductible within defined limits.¹
2. Benefits, whether or not forfeitable, are not currently included in the employee's gross income.²
3. The plan's assets accumulate on a tax-free basis during the accumulation phase. (Note: Though it doesn't normally occur, if a plan produces unrelated business taxable income, the plan will be required to pay income taxes on that income.³)
4. Distributions made to participants are taxable only as received. (See Chapter 15, "Taxation of Retirement Plan Distributions."⁴)
5. Employers with fewer than 100 employees earning compensation over \$5,000 per year may be able to claim a business tax credit equal to 50 percent of qualified startup costs of an eligible employer plan.

¹ IRC Sections 402, 404.

² IRC Sections 402(a), 403(a).

³ IRC Sections 501(a) and (b), 511, 512(b).

⁴ IRC Section 72.

The maximum credit is \$500 per year, which may be taken for up to three years. (See Chapter 1, "Introduction."⁵)

6. Distributions may be eligible for rollover or special tax treatment. (See Chapters 15; 16, "Rollovers and Portability;" and 17, "State Taxation of Nonresidents.")
7. The funds in the retirement plan are protected from the creditors of the participants. (See Chapter 18, "Creditor Protection.")
8. Employers may also find that qualified plans:
 - a. Attract and retain qualified employees.
 - b. Encourage loyalty among employees by the use of vesting schedules.
 - c. Serve as a competitive advantage when hiring new employees.
 - d. Can be designed to provide significant benefits for the owners or key employees with reduced contributions or benefits for the rank and file employees.
9. To recognize that the employer is already providing some retirement benefits through the employer's payment of one half of the social security benefits, a retirement plan may take advantage of something called "permitted disparity". (For a discussion of *permitted disparity*, see Chapter 7, "Permitted Disparity—Integration of Defined Contributions.")⁶ Plan contributions favor higher paid employees when permitted disparity is utilized.

Practice Pointer: With sufficient compensation, the maximum annual contribution that may be made to a participant (\$45,000 in 2007, plus \$5,000 catch-up contributions if age 50 or older) is achievable in an integrated qualified plan. However, the \$45,000 limit has to be reduced (see Chapter 7) in the case of a highly-compensated employee (HCE) under a simplified employee pension plan (SEP) if the SEP utilized permitted disparity. The reduction cannot exceed \$5,265.00.⁷ Compared to a qualified plan's limit of \$45,000 (plus catch-up contributions), only \$39,735.00⁸ may be contributed to a SEP plan when the plan is integrated at the taxable wage base amount; a frequently used level.

SEP and savings incentive match plan for employees (SIMPLE) plans are more fully discussed in Chapter 2, "Simplified Employee Pension Plans—SEP and SARSEP;" and Chapter 3, "SIMPLE Plans."

Qualified Plan Disadvantages

Operating and maintaining a qualified retirement plan clearly has some disadvantages (due to the need to operate the plan in accordance with the rules and regulations) such as:

- Fiduciary liability
- Administrative burdens and filing requirements, that is, the requirements of the Department of Labor (DOL), the IRS, and the Pension Benefit Guaranty Corporation (PBGC)

⁵ IRC Section 25E.

⁶ IRC Sections 401(l), 402(h)(2)(B); 408(k)(3)(D).

⁷ \$97,500 (the 2007 taxable wage base) × .057 (maximum permitted disparity rate).

⁸ Plus catch-up contributions if permitted under a grandfathered SARSEP. At lower integration levels, higher contributions are permitted to be made for an HCE.

- Administrative costs
- Legal responsibility for maintaining qualified status of plan
- Recordkeeping requirements

Depending upon the plan type chosen, contributions may be required each year or may be discretionary. Contribution flexibility is an issue that must be considered by the employer.

Qualified Plan Trust Requirements

A trust forming part of a pension, profit-sharing, or stock bonus plan must meet the following tests to constitute a qualified trust under IRC Section 401(a).⁹ In general, the trust must:

- Be created or organized in the United States,¹⁰ and it must be maintained at all times as a domestic trust in the United States.¹¹
- Be established by an employer for the exclusive benefit of his employees or their beneficiaries.¹²
- Must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan.
- Specify the time and method of distribution and must satisfy the minimum required distribution requirements of IRC Section 401(a)(9).
- Make it impossible at any time (before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust) for any part of the corpus or income to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.
- Be part of a plan that satisfies the minimum participation standards or which benefits such employees as qualify under a classification set up by the employer and found by the Commissioner of Internal Revenue not to be discriminatory in favor of certain specified classes of employees.¹³
- This requirement must be satisfied during at least one day in each quarter.¹⁴
- Be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees.¹⁵ In addition, all optional forms of benefit, ancillary benefits, and other rights and features available to any employee under the plan (benefits, rights, and features) must be made available in a nondiscriminatory manner. Benefits, rights, and features generally will meet this requirement only if each benefit, right and feature satisfies a *current availability* requirement and an *effective availability* requirement.¹⁶
- Be part of a plan which provides the nonforfeitable rights described in IRC Section 401(a)(7) relating to minimum vesting standards.

⁹ Treas. Reg. Section 1.401-1(a)(3).

¹⁰ As defined in IRC Section 7701(a)(9).

¹¹ DOL Reg. Section 2550.404b-1.

¹² IRC Section 401(a)(2)

¹³ IRC Section 410(b); Treas. Reg. Section 1.401-3.

¹⁴ IRC Section 401(a)(6).

¹⁵ IRC Section 401(a)(4), Treas. Reg. Sections 1.401-4; 1.401(a)(4).

¹⁶ See Treas. Regs. Sections 1.401(a)(4)-1(b)(3), 1.401(a)(4)-4(a).

- Provide that forfeitures under a pension plan must not be applied to increase the benefits any employee would receive under such plan.¹⁷ (Profit sharing plans, including 401(k) plans, are not subject to this rule.)
- Provide that if the plan benefits any self-employed individual who is an owner-employee, that contributions by or on behalf of that owner-employee be made only with respect to the earned income of such owner-employee which is derived from the trade or business from which the plan is established.¹⁸

Reversions From Plans

The plan must provide that it is impossible at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, for any part of the funds to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.¹⁹ Thus, no contributions or other amounts may be refunded to the employer. However, a plan (other than a SEP or SARSEP) may provide for the return of a contribution (and any earnings) under limited circumstances in which:

1. The contribution is conditioned on the initial qualification of the plan. For this rule to apply, an application for determination must be made to the IRS within the time prescribed by law for filing the employer's return for the taxable year in which such plan was adopted (or such later date as the Secretary of Treasury may prescribe) and the plan receives an adverse determination from the IRS with respect to its qualification.²⁰
2. A plan may provide for the return to the employer of contributions made by reason of a good-faith mistake of fact and of contributions conditioned on deductibility if there has been a good-faith mistake in determining deductibility. Earnings attributable to any excess contribution based on a good-faith mistake may not be returned to the employer, but losses attributable to such contributions must reduce the amount returned.²¹
3. Employer contributions made to satisfy the quarterly contribution requirements applicable to most defined benefit plans may revert to the employer if the contribution is conditioned on its deductibility, a requested private letter ruling disallows the deduction, and the contribution is returned to the employer within one year from the date of the disallowance of the deduction.²² A letter ruling request may not be needed if the employer contribution is less than \$25,000 and certain other requirements are met.²³
4. Upon the termination of a pension plan (but not a profit-sharing plan) and all fixed and contingent liabilities to the employees and their beneficiaries have been satisfied, the employer may recover any surplus existing because of actuarial "error," provided the plan specifically provide for such a reversion.²⁴

¹⁷ IRC Section 1.401-7.

¹⁸ IRC Section 401(d).

¹⁹ IRC Section 401(a)(2).

²⁰ ERISA Section 403(c)(2)(B); Rev. Rul. 91-4 (1991-1 CB 54).

²¹ ERISA Section 403(c)(2)(A), 403(c)(2)(C); Rev. Rul. 91-4 (1991-1 CB 54).

²² Rev. Proc. 90-49 (1990-2 CB 620).

²³ Rev. Proc. 90-49, Section 4 (1990-2 CB 620); see also Ltr. Ruls. 9021049 (Feb. 26, 1990), 8948056 (Sept. 8, 1989).

²⁴ Treas. Reg. Section 1.401-2(b); Rev. Ruls. 70-421 (1970-2 CB 85), 71-152 (1971-1 CB 126), 73-55 (1973-1 CB 196), 71-149 (1971-1 CB 118); ERISA Section 4044(d)(1).

If a qualified plan maintains a separate account that provides for the payment of medical benefits to retired employees, their spouses and their dependents, any amount remaining in such an account following the satisfaction of all liabilities to provide the benefits must be returned to the employer even though liabilities exist with respect to other portions of the plan.²⁵

Life Insurance Considerations

There is no requirement that a qualified plan must provide an insured death benefit; upon death, it is acceptable for a plan to simply pay out the participant's account value to his beneficiaries.

Generally, the funding of the benefits in a qualified retirement plan is provided by investing in stocks, bonds, mutual funds, and the like. In addition, life insurance can be one of the investments in which the retirement plan account is invested. When life insurance is a part of a qualified retirement plan, there are a number of tax and nontax issues that need to be considered.

Although some rare individuals may be able to "self-insure" against a loss of earning power in the event of death, most individuals are unable to accumulate sufficient funds early in life to provide the dollars necessary to pay for such expenses as a mortgage, education for children left behind, and other debts and expenses. If the retirement plan so provides, an individual may have the option of purchasing life insurance protection within a qualified plan. The question of whether life insurance should be purchased within a plan or outside of the plan is debated by many experts, but the simple answer is, "It depends."

An insured death benefit in a qualified retirement plan is fully included in the estate of the participant. Though the ultimate fate of the estate tax system is in flux at this time, if a significant amount of life insurance is to be provided to a participant in a qualified retirement plan, the inclusion of that death benefit in the estate for estate tax purposes would not be particularly welcome. Given the desirability of keeping life insurance proceeds out of the insured's estate, some professionals have developed the concept of the *subtrust* to own the life insurance policy.²⁶ It has been questionable for many years as to whether this concept would actually work, and now we have some informal guidance from the Service on that question. In a technical advice memorandum issued in October, 2006, the IRS provided explicit information as to why the subtrust concept is not acceptable and actually would lead to disqualification of the plan.

Under IRC Section 79, an employer has the ability to provide up to \$50,000 of group-term life insurance to employees (outside of the retirement plan) and deduct the cost without the employee having to recognize the benefit as current income. Any coverage offered in excess of that amount would cause the employee to recognize a current economic benefit (PS-58/Table 2001 amounts).²⁷ On the other hand, the employer may offer the employee a death benefit through the qualified plan and deduct the cost of the insurance as a retirement plan contribution. (See Appendix D, "Employee Benefits Limits.")

²⁵ IRC Section 401(h)(5).

²⁶ See, Gary S. Lesser, *Life Insurance Answer Book for Qualified Plans and Estate Planning* (3rd Ed.). New York: Panel Publishers, 2002. Chapter 6.

²⁷ See Notice 2002-8, IRB 2002-04, page 398, regarding the tax treatment of split-dollar life insurance arrangements. The Notice replaced the outdated P.S. 58 table with a 2001 table. The new table more accurately reflects longer life expectancies and has the effect of shrinking the premium payment. Notice 2002-8 republished the 2001 PS 58 cost table that was issued in Notice 2001-10. The 2001 Table or the insurer's own published premium rates may be used instead of the rates in the 2001 Table, if such rates are available to all standard risks who apply for initial issue one-year term insurance. (See <http://www.irs.gov/pub/irs-irbs/irb02-04.pdf>.)

Suitability

There are two basic conditions that should be met before life insurance can be considered appropriate or suitable inside a qualified plan: the participant must have a need for life insurance; and the only readily available source of dollars for the premium are inside the qualified plan. On the other hand, if a participant has a need for life insurance, the participant is receiving the maximum allowable contribution to a qualified plan, and the participant has additional dollars to pay the premium for the insurance needed, then it is quite probably inappropriate to place the insurance inside the qualified plan. There are other instances in which purchasing insurance in a qualified plan is advantageous. Certain employees may be uninsurable because of poor health and are unable to buy an individual life insurance policy at any price. Some insurance companies will offer limited amounts of life insurance on a guaranteed-issue basis inside a pension plan so long as insurance is purchased for most or all of the plan's participants. Thus, insurance inside the retirement plan may fulfill a need that may otherwise go unmet.

Note. The first few years of the life of a traditional whole life (or permanent) insurance contract are the years in which the cash-value accumulation is extremely low. After those first years, the investment aspect of insurance improves dramatically over time. Thus, it could be argued that qualified plan dollars, which are pretax dollars (ignoring the PS-58/Table 2001 costs), are extremely efficient dollars to use for the first few years of the policy. After those first few years, it is possible that the participant could purchase the policy from the plan (following specific rules of the Department of Labor), for its comparatively low surrender value, and enjoy those years of higher cash buildup outside the plan. If this procedure is contemplated, it is necessary that close attention be paid to the conditions that apply. Also, the plan document must have the necessary provisions to make this process work.²⁸

New Fair-Market Value Valuation Rules

A new revenue procedure issued in conjunction with proposed regulations provides a temporary safe harbor for determining fair market value (FMV) of a contract for purposes of a participant purchasing that contract from the plan.²⁹ Fully insured plans under IRC Section 412(i) are subject to special rules (discussed elsewhere).³⁰ The regulations prevent taxpayers from using artificial devices to understate the value of the contract. Under the new rules, any life insurance contract transferred from an employer or a tax-qualified plan to an employee must be purchased (or taxed) at its full FMV.

Previously, regulations did not define the terms *fair market value* and *entire cash value*.³¹ The proposed regulations would clarify that, where the regulations under IRC Section 402(a) refer to the *entire cash value* of a contract, such term should be interpreted as FMV.³² Thus, when a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the FMV of such contract is generally included in the distributee's income and not merely the entire cash value of the contracts. FMV for this purpose would be defined as the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed. This prevents the

²⁸ Prohibited Transaction Exemption 92-6, as issued by the Department of Labor, allows individuals, including owner-employees, to purchase a life insurance policy from a plan. The exemption expands the original Prohibited Transaction Exemption 77-8, but certain requirements must still be met, including that the policy would otherwise be surrendered if not purchased from the plan. Therefore, care must be taken that the plan document allow for the purchase of the policy by a participant under such circumstances.

²⁹ Rev. Proc. 2004-16 (2004-10 IRB 559__1__); Prop. Reg. NPRM REG-126967-03 (2004-10 IRB 566).__ FR __)

³⁰ Rev. Ruls. 2004-20 (2004-10 IRB 546__1__), 2004-21 (2004-10 IRB 544__1__).

³¹ See, Treas. Reg. Sections 1.402(a)-1(a)(1)(iii), 1.402(a)-1(a)(2).

³² Prop. Treas. Reg. Section 1.402(a)-1(a)(1)(iii) and 1.402(a)-1(a)(2) (69 F.R. 7384, Feb. 17, 2004).

artificial reduction of cash surrender value from reducing the value of the life insurance contract for tax purposes when it is distributed or purchased from the plan.

Under the interim rules, the cash value of a life insurance contract distributed from a qualified plan may be treated as that contract's FMV. The rules, effective February 13, 2004, permit the use of values that should be readily available from insurance companies because the cash value is an amount that, in the case of a flexible insurance contract, is generally reported in policyholder annual statements, and in the case of traditional insurance contracts, is fixed at issue and provided in the insurance contract.

A plan may treat the cash value as the contract's FMV at the time of distribution if that cash value is at least as large as the aggregate of (1) the premiums paid from the date of issue through the date of distribution, plus (2) any amounts credited to the policyholder with respect to those premiums, minus (3) reasonable mortality charges and reasonable charges, but only if they are actually charged on or before the distribution date and are expected to be paid.

If the contract is a variable contract, a plan may treat the cash value as its FMV at the time of distribution provided that the cash value is at least as large as the aggregate of (1) the premiums paid from the date of issue through the date of distribution, plus (2) all adjustments made with respect to those premiums during the period that reflect investment return and the current market value of segregated asset accounts, minus (3) reasonable mortality charges and reasonable charges, but only if they are actually charged on or before the distribution date and are expected to be paid.

Interim Valuation Method

Pending the issuance of the proposed regulations in final form, Revenue Procedure 2004-16 prescribes an interim method of valuing insurance contracts. Under the *interim valuation method*, the cash value (without reduction for surrender charges) may be treated as the FMV of a contract, provided the cash value is no less than the amount computed using the following formula:

$$a + b - c$$

- a Equals the premiums paid from the date of issue through the date of determination.
- b Equals any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends, and similar income items (whether under the contract or otherwise). In the case of variable contracts, *by* equals all adjustments made with respect to the premiums paid from the date of issue through the date of determination (whether under the contract or otherwise) that reflect investment return and the current market value of segregated asset accounts.
- c Equals reasonable mortality charges and reasonable other charges which are actually charged on or before the date of determination and are expected to be paid.

The *date of determination* is the date of a distribution, in the case of valuing a contract distributed from a qualified plan.

Arguments Against Life Insurance in Qualified Plans

The major arguments against offering life insurance in a qualified plan are as follows:

1. *Why put a shelter in a shelter?* Arguably, a life insurance contract is a tax shelter, inasmuch as the inside buildup of cash value is not currently taxed. A qualified plan by its very nature is also a shelter. Certainly, it would be unwise, for example, to put tax-free bonds earning 2 percent in a plan if taxable bonds with an equal investment risk paying 5 percent were available. In either case, the trust is not going to pay tax; so why take the lower return!
2. Purchasing life insurance in the plan will generally *lower the total value of the account available at retirement*. All life insurance contracts charge for providing a death benefit, and that charge will, without question, reduce the funds available to provide retirement benefits in a defined contribution plan. (Note: In a defined benefit plan, the cost of life insurance protection is in addition to the plan's normal cost of providing retirement benefits.)
3. *Administrative concerns*. The purchase of life insurance adds complexity to plan administration. A life insurance policy is typically accounted for on a participant-directed basis. Often, it is difficult to obtain accurate data from an agent or insurer regarding cash value or FMV as of the valuation date, premiums paid during the plan year, and any dividends paid and how they were applied, as well as commission information for the Form 5500, Schedule A.
4. *Costs of protection is taxable*. Having to include a certain amount of taxable income utilizing the PS-58/Table 1 amounts reduces some of the advantages of purchasing life insurance with pretax dollars.³³
5. *Difficulty in removing a policy*. Once an individual reaches retirement age, it becomes difficult to distribute life insurance policies. However, there are several methods to handle this issue. These methods include the purchasing of the policy from the plan after having the plan take a policy loan from the policy for the maximum cash value. Then the participant may purchase the policy for its new, current value, which is now very low (cash value minus the loan amount), and the loan proceeds may be distributed to the participant with the balance of the participant's account. Alternatively, the policy could be distributed to the participant and the participant would pay tax on the full value of the policy. The participant could borrow from the policy to pay the taxes. Of course, the plan can also surrender the policy and the proceeds distributed with the balance of the participant's account.
6. Life insurance in a defined benefit plan is not subject to as much criticism as it is in a defined contribution plan. In the small-plan environment, where the size of the contribution (and therefore the deduction) is important, life insurance in a defined benefit plan will generally increase the amount of the deductible contribution. In other words, since the amount of the benefit in a defined benefit plan is guaranteed, the purchasing of life insurance only increases the total benefits being provided by the plan, and the deductible cost of the plan to the employer. The employee receives only the added benefit of the insurance, while suffering no reduction in his retirement benefit as a result of the purchase of the insurance.

Prudence

It may not always be prudent to purchase life insurance in a qualified plan. For example, it would not be prudent to purchase whole life insurance with 50 percent of each year's contribution for participants in a plan that has high turnover. The result would be very expensive to participants who terminate with only a few

³³ See IRS Notice 2002-8 (2002-1 CB 398); Rev. Rul. 66-110 (1966-1 CB 12).

years under the plan (and the policy). Most of such a participant's account would have been absorbed in the acquisition costs of the insurance. On the other hand, a competitive insurance contract will provide a fair rate of return (in addition to the death benefit) for a participant who has many years in a plan (and under the policy). Variable life contracts are available today, which allow a policyholder to direct the investment of the policy's cash values among an assortment of investment categories similar to mutual funds. Although charges still apply for the pure cost of insurance and the insurance company's administrative costs, the remaining investment aspect of the policy can offer competitive returns. In recent years, there has been litigation in which plan trustees were questioned as to the prudence of using whole life contracts in a qualified plan.³⁴

Limits on Incidental Benefits

Nonpension benefits must be incidental to the main purpose of the plan—to provide benefits generally at retirement. Incidental benefits are generally benefits other than pure pension benefits offered under a qualified plan.³⁵

A pension plan (that is, a money-purchase plan or a defined benefit plan) may provide for payment of a pension as the result of a disability and for the “payment of incidental death benefits through insurance or otherwise.” A pension plan will not be qualified if it provides for the payment of benefits not customarily included in a pension plan, such as layoff benefits and benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in IRC Section 401(h)).³⁶

A profit-sharing plan may provide disability and incidental death benefits in the same manner as a pension plan. In addition, a profit-sharing plan may provide that amounts allocated to the account of a participant may be used to provide incidental life, accident, or health insurance for a participant's family.³⁷

After-Tax Contributions

The IRS has ruled that the incidental benefit restriction does not apply to life insurance or death benefits purchased with voluntary, nondeductible (that is, after-tax) employee contributions.³⁸

Note. After-tax contributions are subject to the IRC Section 401(m) nondiscrimination test and the IRC Section 415 limits on annual additions. The 401(m) test generally limits the amount of after-tax and matching contributions allocated to highly compensated employees (HCEs) in relation to contributions allocated to non-highly compensated employees (NHCEs).³⁹

Rollovers and Transfers

The incidental benefit restriction generally applies to aggregate employer (that is, pretax) contributions allocated to a participant. Amounts that are rolled into the plan from other plans are generally not included in the calculations of what may be spent for participant insurance.

Incidental Defined Contribution Plan Limit

The determination of when a death benefit under a defined contribution plan is incidental has been largely a creation of revenue rulings. The basic rule is that ordinary or whole life insurance purchased under a defined contribution plan is incidental if the aggregate premiums for life insurance in the case of each par-

³⁴ *Framingham Union Hosp* (D Mass, settled by consent Mar 14, 1990); *DOL v. Flexcon Profit Sharing Plan* (settled by consent Dec 10, 1993).

³⁵ See, Rev. Rul. 69-421, Part 2(n) (1969-2 CB 59).

³⁶ Treas. Reg. Section 1.401-1(b)(1)(i).

³⁷ Treas. Reg. Section 1.401-1(b)(1)(ii).

³⁸ Rev. Rul. 69-40 (1969-2 CB 58); Ltr. Rul. 9339024 (Jul. 7, 1993).

³⁹ IRC Section 401(m).

ticipant are less than 50 percent of the aggregate contributions allocated to the participant at any particular time.⁴⁰ In the case of the purchase of other types of life insurance, however, the limit is a maximum of 25 percent of contributions.⁴¹ The 25 percent is derived from the assumption that a 50 percent contribution used to pay premiums on ordinary life insurance is equivalent to a 25 percent pure insurance cost "since only approximately one-half of the premiums paid for such policies are for pure insurance protection."⁴²

The 25 Percent Limit

Term, universal, and other life insurance policies not considered ordinary life policies are subject to the 25 percent limit. Ordinary life policies are defined as those that provide both nonincreasing premiums and non-decreasing death benefits.⁴³ The IRS has treated a variable life policy as an ordinary whole life policy where it provided a stipulated level amount of death benefit and scheduled level premiums.⁴⁴ In another ruling, the IRS reviewed a policy providing two alternative insurance plans, both with a level amount of coverage, but one consisting of term protection and the other of lifetime protection. It was possible to account for the premiums between the two. The IRS treated the lifetime protection as ordinary life and the term protection as other than ordinary life for purposes of the incidental benefit test.⁴⁵

Policy Dividends

Policy dividends applied to purchase paid-up additions must be taken into account in applying the incidental benefit limitations.⁴⁶ Thus, the dollar amount of such policy dividends so used must be aggregated with other premiums paid and the aggregate amount may not exceed the 25 percent/50 percent limits.

Any Time Rule

Life insurance is incidental if the aggregate of life insurance premiums for each participant does not exceed 25 percent or 50 percent, as applicable, of the aggregate contributions allocated to the credit of the participant at any particular time.⁴⁷ Thus, it is a cumulative, historical test.

Incidental Defined Benefit Plan Limits

Under a defined benefit plan, life insurance will be considered incidental if the death benefit does not exceed 100 times the amount of the participant's anticipated monthly life annuity. Actuarially, the 100-to-1 rule is considered to be the equivalent of the 25 percent rule.⁴⁸ The monthly life annuity for purposes of the 100-to-1 rule is the pension that would have been payable to the participant at normal retirement date if he or she had continued in service to that date earning the compensation in effect at the time of death.⁴⁹

Post-Retirement Benefits

The incidental death benefit cannot extend beyond retirement. This means that the plan must require that upon retirement the life insurance policy must be either (1) converted to cash to provide retirement income or

⁴⁰ Rev. Rul. 54-51 (1954-1 CB 147).

⁴¹ Rev. Rul. 66-143 (1966-1 CB 79).

⁴² Rev. Rul. 74-307 (1974-2 CB 126).

⁴³ Rev. Ruls. 66-143 (1966-1 CB 79), 70-611 (1970-2 CB 89), 76-353 (1976-2 CB 112).

⁴⁴ Ltr. Rul. 9014068 (Jan. 11, 1990).

⁴⁵ Ltr. Rul. 8725088 (Mar. 27, 1987).

⁴⁶ Ltr. Ruls. 9106022 (Nov. 9, 1990), 9215055 (Jan. 16, 1991).

⁴⁷ Rev. Rul. 66-143 (1966-1 CB 79).

⁴⁸ Rev. Ruls. 60-83 (1960-1 CB 157), 66-143 (1966-1 CB 79), 68-31 (1968-1 CB 151), 68-453 (1968-2 CB 163), 70-611 (1970-2 CB 89), 85-15 (1985-1 CB 132).

⁴⁹ Rev. Rul. 61-121 (1961-2 CB 65).

(2) distributed to the employee.⁵⁰ The same limitation has been applied to money-purchase pension plans.⁵¹ Death benefits under defined benefit pension plans have also been held to be limited to preretirement.⁵²

Note. Each plan must apply the incidental benefit test separately.⁵³

Practice Pointer: The qualified joint and survivor annuity and qualified retirement survivor annuity rules generally will apply to a beneficiary designation.⁵⁴

Income Tax Consequences of Life Insurance

The cost of life insurance purchased with qualified plan funds is includible in an employee's gross income in the year the premium is paid. The amount included as income is the lesser of the cost determined under tables published by the IRS (referred to as the PS-58/Table 1 cost), or the published premium rates charged by the insurer for individual one-year term insurance available to standard risks.

Even though PS-58/Table 1 costs are currently taxable to an employee, they are not subject to the 10 percent excise tax on early distributions under IRC Section 72(t).⁵⁵ Neither do the 20 percent mandatory withholding requirement and voluntary withholding requirements apply to PS-58/Table 1 costs.⁵⁶

Reporting PS-58/Table 1 Costs

The instructions to Form 1099-R,⁵⁷ indicate that PS-58/ Table 1 costs are reported on that form. Once the policyholder is no longer employed, the insurer should report the annual PS-58/Table 1 costs on Form 1099-R.

Practice Pointer: A record of cumulative PS-58/Table 1 costs should be maintained for any policy with a cash value for IRS tax reporting purposes. Because the taxed PS-58/Table 1 costs constitute basis in such a policy, such basis information will be needed, for example, if the policy is distributed to the employee.

Death Before Retirement

Upon the death of a participant in a qualified plan before retirement, the difference between the face amount of the policy and its cash surrender value, if any, is exempt from income tax as death proceeds under IRC Section 101(a), if the insurance cost has been taxed to the employee as PS-58/Table 1 costs.⁵⁸ The cash surrender value would be treated as taxable upon distribution, and that value would be reduced by the sum of the PS-58/Table 1 costs already taxed to the employee.⁵⁹

⁵⁰ Rev. Ruls. 54-51 (1954-1 CB 147), 57-213 (1957-1 CB 157), 60-84 (1960-1 CB 159).

⁵¹ Rev. Rul. 66-143 (1966-1 CB 79).

⁵² Rev. Rul. 85-15 (1985-1 CB 132); Field Service Advice 1999-633.

⁵³ Rev. Ruls. 70-28 (1970-1 CB 86), Rev Rul 71-25 (1971-1 CB 125).

⁵⁴ IRC §§ 401(a)(11), 417; ERISA § 205.

⁵⁵ Notice 89-25, Q&A 11 (1989-1 CB 662).

⁵⁶ Treas. Regs. Sections 1.402(c)-2, Q&A 4(f), 35.3405-1.

⁵⁷ Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, Etc.*

⁵⁸ Treas. Reg. Section 1.72-16(c)(4).

⁵⁹ Treas. Reg. Section 1.72-16(b).

Exhibit 4-1. Table 2001—Interim Table of One-Year Term Premiums for \$1,000 of Life Insurance Protection (2002-4 I.R.B.)

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
0	\$ 0.70	35	\$ 0.99	70	\$ 20.62
1	\$ 0.41	36	\$ 1.01	71	\$ 22.72
2	\$ 0.27	37	\$ 1.04	72	\$ 25.07
3	\$ 0.19	38	\$ 1.06	73	\$ 27.57
4	\$ 0.13	39	\$ 1.07	74	\$ 30.18
5	\$ 0.13	40	\$ 1.10	75	\$ 33.05
6	\$ 0.14	41	\$ 1.13	76	\$ 36.33
7	\$ 0.15	42	\$ 1.20	77	\$ 40.17
8	\$ 0.16	43	\$ 1.29	78	\$ 44.33
9	\$ 0.16	44	\$ 1.40	79	\$ 49.23
10	\$ 0.16	45	\$ 1.53	80	\$ 54.56
11	\$ 0.19	46	\$ 1.67	81	\$ 60.51
12	\$ 0.24	47	\$ 1.83	82	\$ 66.74
13	\$ 0.28	48	\$ 1.98	83	\$ 73.07
14	\$ 0.33	49	\$ 2.13	84	\$ 80.35
15	\$ 0.38	50	\$ 2.30	85	\$ 88.76
16	\$ 0.52	51	\$ 2.52	86	\$ 99.16
17	\$ 0.57	52	\$ 2.81	87	\$ 110.40
18	\$ 0.59	53	\$ 3.20	88	\$ 121.85
19	\$ 0.61	54	\$ 3.65	89	\$ 133.40
20	\$ 0.62	55	\$ 4.15	90	\$ 144.30
21	\$ 0.62	56	\$ 4.68	91	\$ 155.80
22	\$ 0.64	57	\$ 5.20	92	\$ 168.75
23	\$ 0.66	58	\$ 5.66	93	\$ 186.44
24	\$ 0.68	59	\$ 6.06	94	\$ 206.70
25	\$ 0.71	60	\$ 6.51	95	\$ 228.35
26	\$ 0.73	61	\$ 7.11	96	\$ 250.01
27	\$ 0.76	62	\$ 7.96	97	\$ 265.09
28	\$ 0.80	63	\$ 9.08	98	\$ 270.11
29	\$ 0.83	64	\$ 10.41	99	\$ 281.05
30	\$ 0.87	65	\$ 11.90		
31	\$ 0.90	66	\$ 13.51		
32	\$ 0.93	67	\$ 15.20		
33	\$ 0.96	68	\$ 16.92		
34	\$ 0.98	69	\$ 18.70		

Chapter 5

Compensation and Earned Income

How a retirement plan defines compensation can have a tremendous impact on the cost of providing promised benefits or on how fixed or discretionary contributions are allocated among eligible employees.

Compensation

In most cases, compensation is defined in a circular manner. For purposes of the nondiscrimination rules and any other provision of the Internal Revenue Code (IRC or the Code) that *specifically* refers to IRC Section 414(s), *compensation* means compensation as defined in IRC Section 415(c)(3), the all inclusive definition. IRC Section 414(s), however, permits an employer to either include or exclude elective contributions from this all inclusive definition for some, but not necessarily all purposes. For example, elective contributions made under the plan cannot reduce the compensation upon which a minimum IRC Section 416 top-heavy contribution is required. Specifically, IRC Section 416(i)(D) refers to IRC Section 414(q), that in turn refers to the basic all-inclusive definition found in IRC Section 415(c)(3); thus, the reduction to compensation allowed for elective contributions under IRC Section 414(s) never comes into play when determining which employees are entitled to top-heavy contributions. Compensation may have a slightly different definition for other purposes of the Code. For a self-employed individual, *compensation* means the earned income of that individual (discussed below).¹ The definition of compensation found in the plan document must generally be used. If the plan provides a maximum cap on compensation, that limit is the most that can be considered under the plan and for deduction purposes.

Compensation in excess of \$225,000 (the 2007 maximum limit) is not taken into account.² The base compensation limit of \$225,000 (the 2007 limit) is indexed for inflation in increments of \$5,000.³ See Appendix D, "Employee Benefits Limits," for indexed employee benefits limits for other years.

Note. Prior to the issuance of the proposed regulations in 2005, comprehensive section 415 regulations were last issued in 1981. For more than twenty-five years, updates to the 1981 regulations to reflect statutory and other changes were incorporated in a series of revenue rulings and notices. The proposed regulations both consolidated all of the section 415 rules in updated regulations and reflected certain statutory changes not

¹ See, IRC Sections 404(a)(12), 415(c)(3)(B), 408(k)(7)(B) regarding SEP.

² IRC Sections 401(a)(17), 414(s)(1); Notice 2003-73 (2003-45 IRB 1017).

³ IRC Section 401(a)(17).

previously addressed in IRS guidance. The final rules issued in May 2007, adopt the 2005 proposed regulations with certain changes, including changes made by the Pension Protection Act (PPA).⁴

Caution. *The final regulations under IRC Section 415 are effective for limitation years beginning on or after July 1, 2007. Most calendar year plans will begin applying the new rules as of January 1, 2008.*

Amounts that are received for personal services actually rendered in the course of employment with the employer are generally treated as compensation to the extent that the amounts are includable in income. Generally, IRC Section 415(c)(3) compensation is the compensation of the participant from the employer for the year and generally includes but is not limited to:⁵

- Wages and salaries.
- Fees for professional services.
- Other amounts received (cash or noncash) for personal services actually rendered in the course of employment for the employer, including, but not limited to the following items:
 - Commissions and tips
 - Fringe benefits
 - Bonuses
 - Reimbursements under nonaccountable plans⁶
- Amounts received through accident and health plans (or other similar arrangement having the effect of accident or health insurance) under IRC Section 104(a)(3), but only to the extent that these amounts are includible in the gross income of the employee.
- Amounts received through accident and health plans for personal injuries or sickness under IRC Section 105(a), but only to the extent that these amounts are includible in the gross income of the employee.
- Amounts paid to highly-compensated individuals under a discriminatory self-insured medical reimbursement plan, but only to the extent that these amounts are includible in the gross income of the employee under IRC Section 105(h).
- Reimbursements for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under IRC Section 217 regarding moving expenses.
- The value of non-qualified stock options taxable upon grant to an employee by the employer, but only to the extent that the value of the option is includible in the gross income (very rare) of the employee for the taxable year in which granted.
- The amount includible in the gross income of an employee upon making the election to increase gross income under IRC Section 83(b) regarding property transferred in connection with performance of services.

Amounts included in the gross income of an employee under an ineligible 457(f) plan, or under the rules of IRC Section 409A regarding the inclusion in gross income of deferred compensation under nonqualified deferred compensation plans, or because the amounts are constructively received by the employee. A qualified

⁴ Preamble, Treas. Reg. Section 1.415 (T.D. 9319, 2007-18 IRB 1041 (Apr. 30, 2007)).

⁵ IRC Section 415(c)(3); Treas. Reg. Section 1.415(c)-2(a), 1.415(c)-2(b).

⁶ As described in Treas. Reg. Section 1.62-2(c).

defined contribution plan may contain provisions that impute IRC Section 415 compensation to “permanently and totally disabled” participants,⁷ so that contributions can continue to be made on their behalf. Such contributions must be fully vested when made. In general, a disabled participant’s compensation may continue at the rate of pay in effect immediately before the participant became disabled; however, an individual who was a highly compensated employee (HCE) before his or her disability is not entitled to imputed compensation unless all permanently and totally disabled participants are provided contributions for a “fixed and determinable period.”⁸

Note. IRC Sections 415(c)(3) and 414(s) will automatically be satisfied by the use of wages as defined for income tax withholding purposes, or wages reportable in Box 1 of Form W-2 (which may include certain items that are not wages for withholding purposes).⁹

Various elective deferrals and salary reduction contributions are not subtracted from IRC Section 415 compensation even though they are excluded, if within applicable limits, from taxable income.¹⁰ Compensation generally includes elective contributions contributed under any of the following plan types:¹¹

- A qualified cash or deferred arrangement, for instance, an IRC Section 401(k) plan
- A tax sheltered annuity—that is., an IRC Section 403(b) plan
- A savings incentive match plan for employees (SIMPLE) individual retirement account or annuity (IRA)
- A salary-reduction or elective simplified employee pension plan (SARSEP)
- A nonqualified deferred compensation plan (NQDC) under IRC Section 457(f)
- An IRC Section 125 cafeteria plan.
- Section 402A designated Roth contributions.

However, an employer may provide for the exclusion of elective contributions under the above plan types from the definition of compensation. It should be noted that the exclusion of elective contributions from the definition of compensation under a plan does not reduce the maximum deductible amount, but it is likely to reduce employer-provided contributions or benefits under the plan.

As a design issue, whether elective contributions should reduce compensation under a plan depends upon the number of owners and the level of their elective contributions, compared to the resulting compensation of rank-and-file employees. Once the plan’s allocation or benefit formula is applied, it is easier to determine which methodology best satisfies the employer’s objectives.

Note. The exclusion of elective contributions from the plan’s definition of compensation does not effect the maximum deductible amount (which is computed without reducing compensation by elective contributions under the plan); although it may reduce the level of employer-derived allocations or benefits. If the plan is integrated with Social Security, reducing compensation by elective contributions will reduce the excess compensation upon which integrated contributions are made and, as a design feature, is not generally advantageous if owners are more highly compensated than other participants.

⁷ As defined in IRC Section 22(e)(3).

⁸ IRC Section 415(c)(3)(D). The length of the “determinable period” is not specified

⁹ Treas. Reg. Sections 1.414(s)-1(c)(2), 1.415(c)-2(d)(3).

¹⁰ Small Business Job Protection Act of 1996, Section 1434(a), effective for plan years beginning after 1997.

¹¹ IRC Section 414(s)(2); Treas. Reg. Section 1.414(s)-1(c)(4).

Employers may demonstrate that a definition of compensation is nondiscriminatory using “snapshot” testing on a single day during the plan year, provided that day is representative of the employer’s work force and the plan’s coverage throughout the plan year.¹²

Note. All defined contribution plans maintained by a single employer are treated as a single plan for purposes of IRC Section 415 limits. All members of a controlled group or affiliated service group are treated as one employer in applying the rules of IRC Sections 414(b), (c), (m), and (o). However, the controlled group rules are modified under IRC Section 415(h) by substituting “more than 50 percent” for “at least 80 percent.”

Example. Odd Days established a qualified profit-sharing plan for its eligible employees. Even Days establishes a money-purchase plan for its eligible employees. Marilyn, who is over 50 years old, (directly and indirectly) owns 51 percent of both entities. The remaining stock is broadly diversified. Although Odd and Even are not part of a controlled group under IRC Section 414, Marilyn’s compensation must be aggregated for purposes of determining any limits under IRC Section 415 applicable to either plan.

Example. Same facts as in the preceding example. Marilyn earns \$250,000 from both Odd and Even for the current plan limitation year. Although her plan compensation is limited to \$225,000 under both plans, Marilyn’s contributions under both plans may not exceed \$45,000 in 2007, plus catch-up contributions (up to \$5,000 in 2007 if permitted under the plan) because she is in control of more than one employer.

Limitation Year

The *limitation year* is the calendar year unless another 12-month period is designated in the plan document.¹³ (Nearly every plan will designate the plan year as its limitation year.) For limitation years that begin after December 31, 2001, the maximum annual addition to a defined contribution plan (including a SEP or SARSEP) is the lesser of 100 percent of compensation or \$45,000 (the 2007 limit), plus catch-up contributions of up to \$5,000 (the 2007 limit) if age 50 or older).¹⁴

Proration of the limitation year limit is generally required in the event the plan year is changed (short plan year);¹⁵ however, proration is not required in the plan’s initial or final year.¹⁶ Special rules apply where a controlled group maintains defined contribution plans with different limitation years.

For a defined contribution plan, the limitation year is the basis for measuring the annual addition limits (generally 100 percent of compensation or \$45,000, whichever is less, for 2007) under IRC Section 415(c) and the maximum annual benefit limitations for defined benefit plans under IRC Section 415(b).

Amounts contributed to a SEP are treated as allocated to the individual’s account as of the last day of the limitation year ending with or within the taxable year for which the contribution is made.¹⁷

The IRC Section 415(b) limit applicable to the annual benefit from a defined benefit plan, consists of two separate testing prongs—a dollar limit and a compensation limit. The annual benefit cannot exceed the lesser of these two limits. The dollar limit is \$180,000 for limitation year 2007 and is adjusted for inflation in \$5,000 increments. The compensation limit is 100 percent of the employee’s average compensation for his or her “high 3 years.”¹⁸

¹² Rev. Proc. 93-42 (1993-2 CB 540).

¹³ Treas. Reg. Section 1.415(j)-1(a); Prop. Treas. Reg. Section 1.415(j)-1

¹⁴ IRC Section 415(c)(1).

¹⁵ IRC Section 415(c)(1); Treas. Reg. Section 1.415(j)-1(d); Prop. Treas. Reg. Section 1.415(j)-1(a), 1.415(j)-1(c)(2).

¹⁶ Tom Pevarnik, Deloitte’s *Washington Bulletin*, *Updated 415 Regulations—An In-Depth Review*, Part 5 (item 4) (June 20, 2005). The “guest article” is available at: <http://benefitslink.com/articles/washbull050620.html>.

¹⁷ Treas. Reg. Section 1.415(c)-1(b)(6)(ii)(C).

¹⁸ IRC Section 415(b)(1) and (b)(2); Prop. Treas. Reg. Section 1.415(b)-1(a).

Note. The proposed 415 regulations alter the determination of a participant's average compensation for his or her three highest consecutive years in two respects.¹⁹ First, the proposed regulation disregards any period during which the individual was not an active participant in the plan. As a result, it will no longer be possible for a semi-retired business owner to establish a plan with benefits based on his or her higher compensation earned in the past. Addressing an area of longstanding uncertainty, the proposed regulations state that the IRC Section 401(a)(17) limitation on compensation that a plan may take into account applies to IRC Section 415(b) regarding defined benefit plan limitations. Normally, the 401(a)(17) limit (\$225,000 for 2007) is higher than the 415(b) dollar limit (generally \$45,000 for 2007), "but the latter ratchets upward if benefit commencement is delayed past age 65 and thus will be higher for older participants. While no properly drafted plan will base benefit accruals on compensation in excess of the 401(a)(17) limit, actuarial adjustments for late commencement may increase the amount due to a participant above that figure. The proposed regulations, if adopted, could therefore lead to significant benefit cutbacks for participants who begin receiving their pensions at later ages. The imposition of the 401(a)(17) limit on top of the 415(b) limit does not mean that no participant will ever be able to receive an annual payment in excess of the former. Under Section 415(d)(1)(B), the 100 percent of compensation limit is adjusted for cost-of-living increases after separation from service.²⁰ Hence, post-retirement increases, *for example, ad hoc* COLA's, may lead to a benefit of more than 100 percent of the compensation cap."²¹

Annual Additions

The term "annual additions" generally means the sum for any year of employer contributions, employee contributions, and forfeitures. In addition to applying to qualified defined contribution plans, the limitations on defined contribution plans apply to section 403(b) annuity contracts, simplified employee pensions described in section 408(k), mandatory employee contributions to qualified defined benefit plans, and contributions to certain medical accounts.²² There are, however, several exceptions. Annual additions do not include catch-up contributions made by participants age 50 and over, employer contributions to restore previously forfeited account balances upon repayment of the prior distribution, and restorative payments allocated to a participant's account to restore losses from actions that are reasonably likely to lead to a suit for breach of fiduciary duty under ERISA.²³ Earning credited to restorative payments are not annual additions because they represent earning rather than contributions.

Nondiscriminatory Definition of Compensation

A definition of compensation other than IRC Section 415(c)(3) compensation can also satisfy IRC Section 414(s) if it meets the safe-harbor definition or meets one of the alternative definitions and a nondiscrimination test.²⁴ The safe-harbor definition is IRC Section 415(c)(3) compensation, reduced by:²⁵

1. Reimbursements or other expense allowances

¹⁹ Treas. Reg. Section 1.415(b)-1(a)(5); Prop. Treas. Reg. Section 1.415(b)-1(a)(5).

²⁰ Treas. Reg. Section 1.415(d)-1(a)(ii); Prop. Reg. 1.415(d)-1(a)(2).

²¹ Tom Pevarnik, Deloitte's *Washington Bulletin*, Updated 415 Regulations—An In-Depth Review (Part 2 of 2) (July 5, 2005). The "guest article" is available at: <http://benefitslink.com/articles/washbull050705.html>.

²² IRC Section 415(c)(2).

²³ ERISA, 29 U.S.C. Section 1001 et. seq.; Prop. Treas. Reg. Section 1.415(c)-1(b)(2)(ii)(C); Treas. Reg. 1.415-6(b)(2)(ii); but see previously issued Rev. Rul. 2002-45 (2002-2 C.B. 116) where earning on restorative payments made under the IRS plan correction program (EPCRS, see Chapter 13, "Plan Correction Programs—EPCRS, VFCP and DFVC") were treated as a "restorative payment."

²⁴ IRC Section 414(s)(3).

²⁵ Treas. Reg. Section 1.414(s)-1(c)(3).

2. Fringe benefits (cash and noncash)
3. Moving expenses
4. Deferred compensation
5. Welfare benefits

An alternative definition that defines compensation based on the rate of pay of each employee will also satisfy IRC Section 414(s) if the definition is nondiscriminatory and satisfies other requirements found in the regulations.²⁶

Another alternative definition of compensation can satisfy IRC Section 414(s) if it is reasonable and does not, by design, favor highly compensated employees (HCEs) and it meets a nondiscriminatory requirement. The nondiscriminatory requirement is satisfied if the average percentage of total compensation included under the alternative definition for the employer's HCEs as a group does not exceed by more than a *de minimis* amount the average percentage of total compensation included under the alternative definition for the employer's other employees as a group.²⁷ Self-employed individuals are subject to special rules for purposes of using an alternative definition.²⁸

As an alternative to the IRC Section 415 definition of compensation, a plan, including a simplified employee pension plan (SEP) or a SARSEP, may define compensation using one of the following three definitions used for wage reporting purposes and automatically be deemed to satisfy IRC Section 415(c)(3). The three alternatives do not apply to self-employed individuals treated as employees within the meaning of IRC Section 401(c)(1).

W-2 Earnings

This alternative includes amounts required to be reported under IRC Sections 6041, 6051, and 6052 (wages, tips, and other compensation box on Form W-2, Wage and Tax Statement). That is, compensation is defined as wages within the meaning of IRC Section 3401(a) and all other payments of compensation to an employee by his or her employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under IRC Sections 6041(d), 6051(a)(3), and 6052.²⁹ This definition of compensation may be modified to exclude amounts paid or reimbursed by the employer for an employee's moving expenses, but only to the extent that at the time of the payment it is reasonable to believe that the employee may deduct such amounts under IRC Section 219. Compensation is to be determined without regard to any rules under IRC Section 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (for example, the exception for agricultural labor in IRC Section 3401(a)(2)). The "W-2" definition of compensation excludes elective deferrals from being treated as compensation.

IRC Section 3401(a) Wages

Under this alternative, *compensation* is defined as wages within the meaning of IRC Section 3401(a) (which generally includes, for purposes of income tax withholding at the source, all remuneration for services performed as an employee other than fees paid to a public official) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (for example, the exception for agricultural labor in IRC Section 3401(a)(2)). This definition would include elective deferrals as compensation under the plan.

²⁶ Treas. Reg. Section 1.414(s)-1(e).

²⁷ Treas. Reg. Section 1.414(s)-1(d).

²⁸ Treas. Reg. Section 1.414(s)-1(d)(3)(iii)(B), 1.414(s)-1(g).

²⁹ Treas. Reg. Sections 1.6041-1(a), 1.6041-2(a)(1), 1.6052-1, 1.6052-2; see, too, Treas. Reg. Section 31.6051-1(a)(1)(i)(C).

IRC Section 415 (the Safe-Harbor Section) Compensation

The IRC Section 415 safe-harbor definition of compensation is generally a streamlined version of the full IRC Section 415 definition. It is intended to simplify the full definition by including an employee's basic wages without the required adjustments of the full IRC Section 415 definition. Under this alternative, compensation is defined as wages, salaries, fees for professional services, and other amounts received (without regard to whether an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan, to the extent that the amounts are includable in gross income. Such amounts include but are not limited to commissions paid to salespersons, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan³⁰ and may exclude the previously mentioned items that IRC Section 415 compensation does not include. This definition would include elective deferrals as compensation under the plan.

Compensation Paid After End of "Limitation Year"

Compensation that is paid after a "limitation year" may be used for the prior limitation year under certain circumstances. There is a *de minimis* timing rule that states compensation paid after the end of a limitation year may be used provided the following rules are satisfied:³¹

1. The amounts are earned during the year but paid in the first few weeks of the next limitation year.
2. The amounts are included on a uniform and consistent basis with respect to all similarly situated employees.
3. The same amount is not included in more than one limitation year.

For a defined contribution plan, the limitation year is the basis for measuring the annual addition limits under IRC Section 415(c).

Example. Jean defers from her salary into her employer's SARSEP plan during 2007. The plan year and limitation year coincide with the 2007 calendar year. On January 15, 2008, she receives a check for the pay period that ends on December 31, 2007. Jean may defer from the check received on January 15, 2008 for the 2007 plan.

Note. This rule was clarified under the Proposed 415 regulations issued May 31, 2005. These regulations are not effective until years beginning after December 31, 2006; however plans may use the regulations immediately. Unfortunately there is no reference to salary reduction SEP plans under these new final regulations with respect to this rule.

Caution: *Severance payments are not generally considered compensation and may not have elective deferrals taken from these payments. However, a special rule applies to payments made shortly after the end of the year (see below).*³²

³⁰ As described in Treasury Regulations Section 1.62-2(c)(3).

³¹ Treas. Reg. Section 1.415(c)-2(e)(1)(ii); Prop. Treas. Reg. Section 1.415(c)-2(e)(2).

³² See Preamble, Other Significant Changes, Prop. Treas. Reg. Section 1.415(c)-2, 70 Fed. Reg. 31214–31216 (May 31, 2005).

Deferrals From Post-Severance Payments

An employee may defer, from post-severance payments, payments they would have been entitled to had the employee continued service with the employer. Such payments must also be paid within two and a half months after severance from employment.

Generally, this would include compensation paid for services before severance from employment (such as regular compensation, overtime, bonuses, accrued sick or vacation pay), as long as the employee would have been entitled to these payments had they continued to work, and to payments with respect to leave that would have been available for use if employment had not terminated.³³ Based on the final 415 regulations it is unclear whether this rule will apply however to a SEP or SARSEP Plan.³⁴ Such amounts are also treated as compensation under IRC Section 415.³⁵

Note. Severance pay, unfunded nonqualified deferred compensation, and parachute payments³⁶ are not treated as compensation under IRC Section 415, because the amounts would not have been paid absent the severance from employment. (But see, “Qualified Military Service Payments,” later on in this chapter).

Note. With respect to bona-fide leave payments, the final regulations under Coe Section 415 require that the plan explicitly provide that such post-severance payments are included in compensation. The final regulations also permit payments made post-employment from a nonqualified unfunded deferred compensation plan to be treated as compensation, if the payments would have been made at the same time if the employee had continued employment and the payments are includable in gross income. Such amounts are also treated as compensation under IRC Section 415.³⁷

Note. Under the final regulation severance “regular pay” must be included as compensation, but other payments are optional. IRC Section 415(c)(3) compensation must include certain post-severance “regular pay” that is paid within the specified timeframe described above and that would have been paid had the participant remained employed (such as regular, overtime, and shift differential pay, commissions, bonuses, and other similar compensation). In addition, the final regulations permit, but do not require, plan provisions to specify that any of the following types of post-severance payments be included in IRC Section 415(c)(3) compensation: (1) certain payments within the specified timeframe for accrued bona fide sick, vacation, or other leave (if the participant would have been able to use the leave if employment had continued); (2) certain payments within the specified timeframe under a nonqualified deferred compensation plan (if the payments are taxable and would have been made at that time if the employee had continued in employment); (3) certain payments to a permanently and totally disabled participant (not limited to specified timeframe); or (4) certain differential payments to individuals in qualified military service (not limited to specified timeframe).³⁸

Qualified Military Service Payments

Under recently proposed regulations, the rule generally excluding payments after severance from employment from compensation does not apply to payments to an individual who does not currently perform services for the employer by reason of “qualified military service” to the extent those payments do not exceed the amounts the individual would have received if the individual had continued to perform services for the em-

³³ Treas. Reg. Section 1.415(c)-2(e)(2); Prop. Treas. Reg. Section 1.415(c)-2(e).

³⁴ Preamble, Treas. Reg. Section 1.415 (T.D. 9319, 2007-18 IRB 1041, 1044 (Apr. 30, 2007)) referring only to IRC Section 401(k) and Section 457(b) plans; Prop. Treas. Reg. Section 1.415(c)-2(e).

³⁵ Prop. Treas. Reg. Section 1.415(c)-2(e)(3).

³⁶ See IRC Section 280G(b)(2).

³⁷ Treas. Reg. Section 1.415(c)-2(3)(e)(i).

³⁸ Treas. Reg. Section 1.415(c)-2(e)(3)(i).

ployer rather than entering qualified military service.³⁹ Thus, compensation paid after the 2½ month period described previously may be taken into account (treated as compensation) for contribution purposes.

The term *qualified military service* means any service in the uniformed services⁴⁰ by any individual if such individual is entitled to reemployment rights under such chapter with respect to such service.⁴¹

IRC Section 415 Compensation Exclusions

Under IRC Section 415, the term *compensation* does *not* include the following:⁴²

1. Employer nonelective contributions made on behalf of an employee to a SEP, a qualified plan, or a 403(b) plan, or contributions made to government plans as “pick up” contributions.
2. Contributions made by the employer to a deferred compensation plan, to the extent that, before the application of the Section 415 limits to that plan, the contributions are not includable in the gross income of the employee for the taxable year in which contributed.
3. Distributions from a deferred compensation plan, regardless of whether such amounts are includable in the gross income of the employee when distributed. It should be noted, however, that any amounts received by an employee from an unfunded nonqualified plan are permitted to be considered compensation for Section 415 purposes in the year the amounts are includable in the gross income of the employee.
4. Gain realized from the exercise of nonqualified stock options or when restricted stock (or property) held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture.⁴³
5. Gain realized on the disposition of stock received through exercise of a statutory stock option under IRC Sections 421 or 423.⁴⁴
6. Amounts qualifying for special tax benefits, such as premiums for group term life insurance (but only to the extent that the premiums are not includable in the gross income of the employee).
7. Items “similar to” other excluded items.

Earned Income

The earned income of a self-employed individual who is an employee within the meaning of IRC Section 401(c)(1) is treated as his or her compensation.⁴⁵ The earned income of a partner in an organization established as a limited liability partnership (LLP) or limited liability company (LLC) is also treated as his or her compensation.⁴⁶

Note. Compensation includes the net income from operating oil, gas, or mineral interests or the net earnings of a self-employed writer, inventor, or artist. Nevertheless, a royalty paid for the right to use a copyright or patent or an oil, gas, or mineral property is taxable, although it is not generally treated as earned income.

³⁹ Prop. Treas. Reg. Section 1.415(c)-2(e)(1)(ii), 1.415(c)-2(e)(4).

⁴⁰ As defined in Chapter 43 of title 38, United States Code.

⁴¹ IRC Section 414(u)(1); Treas. Reg. Section 1.415(c)-1(b)(6)(ii)(D); Prop. Treas. Reg. Section 1.415(c)-2(e)(4).

⁴² IRC Sections 415(c)(3); Treas. Reg. Sections 1.415-2(d)(3); Prop. Treas. Reg. Section 1.415(c)-2(c).

⁴³ See IRC Section 83.

⁴⁴ For example, taxable gain resulting from a disqualifying disposition.

⁴⁵ Treas. Reg. Section 1.415-2(d)(2)(ii); Prop. Treas. Reg. Section 1.415(c)-2(b)(2).

⁴⁶ Treas. Reg. Section 1.415(c)-2(b)(2); Prop. Treas. Reg. Section 1.1402(a)-2.

Dividend income (S corporation or otherwise) is a return on invested capital, not a return on labor (wages). It does not count for plan establishment or plan contribution purposes. Suppose, for example, a taxpayer improperly, in the view of the IRS, either inflates his or her S corporation dividend and correspondingly reduces his or her earned income to; for example, reduce Social Security or Medicare taxes or deflates his or her S corporation dividend and correspondingly increases his or her earned income in order to get a higher pension contribution. Under such circumstances, a challenge from the IRS is possible, though not likely, because the IRS maintains that it has the right to recharacterize the split between the two to reflect what it determines is the "economic reality." If the filed return reflects economic reality, dividends do not count toward compensation for plan purposes.⁴⁷ In *Grey's Public Accountant*,⁴⁸ the owner of a Sub S treated himself as an independent contractor and reported payments for services on Form 1099. The Tax Court held that the owner was an employee and that the wages were subject to employment taxes Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA), that is, not Self-Employment Contributions Act (SECA). Can you be an independent contractor for and the sole shareholder of your S corporation? Maybe, depending upon the facts. In *Veterinary Surgical Consultants, P.C.*,⁴⁹ the facts worked against the taxpayer. The corporation did veterinary consulting and had only one employee who was a veterinarian, the president and sole shareholder, and his services were essential to the business. He claimed to be an independent contractor. The Tax Court held that he was an employee. The Court also held, as in *Grey*, that the corporation could not avail itself of the benefits of Section 530 of the Revenue Act of 1978 (which provides for reduced penalties) because the corporation did not have a reasonable basis for treating the worker as an independent contractor. The taxpayer was the only employee and his services were essential to the operation of the business. Arguably, an individual might be considered an independent contractor if their services are not essential to the business and they have another business. For example, Horace is a 25 percent owner in a building contractor, but also does business as a lawyer. Horace does legal work for the contractor and bills them through his law firm.⁵⁰

Note. It may be questionable "whether it is ever reasonable for a taxpayer to treat a statutory employee as a nonemployee for employment tax purposes."⁵¹

Relying on Revenue Ruling 1959-221,⁵² the IRS advised an S corporation shareholder that his distributive share of earnings could not be treated as self-employment income for retirement plan purposes because his services were not a material income producing factor.⁵³ In Revenue Ruling 1959-221 the IRS issued guidance on whether the amounts required to be included in the gross income of a shareholder of an electing small business corporation [S corporation] constitute "net earnings from self-employment" for purposes of the Self Employment Contributions Act of 1954 (SECA). After noting the various Code provisions affecting self-employed individuals, such as IRC Sections 1402(a) and (c), the ruling stated:

[I]t is apparent that income not resulting from the conduct of a trade or business by an individual, or by a partnership of which he is a member, is not includible in computing the individual's net earnings from self-employment. Amounts which must be taken into account in computing a shareholder's income tax by reason of the provisions of section 1373 of the Code, are not derived from a trade or business carried on by such shareholder. Neither the election by a corporation as to the manner in which it will be taxed for Federal income tax purpose nor the consent thereto by the persons who are shareholders results in the consenting

⁴⁷ *Durando v. United States*, 70 F3d 589 (9th Cir. 1995).

⁴⁸ *Grey's Public Accountant, PC v. Commissioner* (119 TC No. 5).

⁴⁹ *Veterinary Surgical Consultants, P.C.* (117 TC No 14, Oct 15, 2001).

⁵⁰ See also *Yeagle Drywall*, TC Memo 2001-284, the taxpayer's services were essential and a 99 percent stockholder was treated as an employee and not an independent contractor.

⁵¹ See discussion in *Joseph M. Grey Public Accountant, P.C. v. Commissioner*, ¶26 (119 T.C. No. 5).

⁵² Revenue Ruling 1959-221 (1959-1 CB 225).

⁵³ Field Service Advice 1999-526 (undated).

shareholder's being engaged in carrying on the corporation's trade or business. Accordingly, amounts which a shareholder is required to include in his gross income by reason of the provisions of section 1373 of the Code should not be included in computing his net earnings from self-employment for Self-Employment Contributions Act purposes.⁵⁴

Keep in mind that amounts earned by partners and shareholder-partners of an LLC are not wages subject to FICA, FUTA, or federal income tax withholding.⁵⁵

Under IRC Section 401(c)(2), earned income for a self-employed person (including a partner in a partnership) refers to net earnings from self-employment in a trade or business in which the personal services of that individual are a material income-producing factor.⁵⁶ After several adjustments, up to \$225,000 (the 2007 limit) of earned income may be considered for plan allocation and employer deduction purposes.⁵⁷ In general, the add-back is limited to contributions that qualify as elective deferrals. The adjustments not only affect one another but also may be affected by other factors. Under IRC Section 401(c)(2), net earnings from self-employment must be reduced by all contributions made by or on behalf of the owner and by the deduction for half of the self-employment tax under IRC Section 164(f). It should be noted that the owner's share of the allowable contribution expense for nonowner employees must be subtracted from business income to arrive at the amount of net earnings from self-employment. In the case of a partnership or a limited liability company, earned income may include guaranteed payments to members.⁵⁸

Note. For taxable years beginning after 2001, elective contributions are added back for the purpose of calculating the employer's maximum deduction (but not (other than for catch-up elective contributions) for the purpose of computing the 25 percent participant exclusion limit in a SEP). Plan provisions may provide that elective contributions may be added back when allocating an employer's nonelective contributions among employees.

IRC Section 1402 defines the term *self-employment income* as net earnings from self-employment derived by an individual during any taxable year. IRC Section 1402(a) provides that the term *net earnings from self-employment* includes an individual's distributive share (whether or not distributed) of income or loss described in IRC Section 702(a)(8) from any trade or business carried on by a partnership of which the individual is a member. IRC Section 1402(a)(13) provides that the distributive share of any item of income or loss of a limited partner is not included under the definition of net earnings from self-employment unless the distributive share is a guaranteed payment to that partner for services actually rendered to or on behalf of the partnership to the extent that such payment is established to be in the nature of remuneration for those services. In the view of the IRS, it is generally not essential that an individual currently be engaged in the day-to-day conduct of a trade or business in order to be carrying on a trade or business. A taxpayer can still be engaged in a trade or business even if there is a temporary hiatus in the conduct of the activities of that trade or business.⁵⁹

Recent cases have adopted more narrow interpretations of what constitutes self-employment income for self-employment tax purposes.⁶⁰ Whether a payment is derived from a trade or business carried on by an individual for purposes of IRC Section 1402 depends on whether, under all the facts and circumstances, a nexus

⁵⁴ Rev. Rul. 1959-221, 1959-1 CB 225, 226-227.

⁵⁵ IRS Legal Memo 200117003 (Apr 27, 2001).

⁵⁶ IRC Section 1402(a).

⁵⁷ IRC Sections 401(a)(17), 404(l).

⁵⁸ Ltr. Ruls. 9525058 (Mar. 28, 1985), 9452024 (Sept 29, 1994), 9432018 (May 16, 1994); see Form 1065, Schedule K-1, line 22.

⁵⁹ *Newberry v. Commissioner*, 76 TC 441, 444 (1981); see also *Reisinger v. Commissioner*, 71 TC 568, 572 (1979); *Haft v. Commissioner*, 40 TC 2, 6 (1963); see also Rev. Rul. 75-120 (1975-1 CB 55), job search costs may be deductible trade or business expenses even if taxpayer is temporarily unemployed.

⁶⁰ IRC Section 1402(a)-(b).

exists between the payment and the carrying on of the trade or business. The Tax Court articulated this nexus requirement in *Newberry v. Commissioner*,⁶¹ observing that, under IRC Section 1402, there must be a nexus between the income received and a trade or business that is or was actually carried on. Put another way, the construction of the statute can be gleaned by reading the relevant language all in one breath: The income must be derived from a trade or business carried on. Thus, the trade or business must be “carried on” by the individual, either personally or through agents or employees, in order for the income to be included in the individual’s “net earnings from self-employment.”⁶²

Generally, the required nexus exists if it is clear that a payment would not have been made but for an individual’s conduct of a trade or business.⁶³ Although the IRS agreed with the Tax Court in *Newberry*, that a nexus must exist, it did not agree with the court’s conclusion in that case that such a nexus cannot exist if an individual is not currently engaged in the day-to-day conduct of a trade or business. Therefore, the IRS declared that it will not follow the decision in *Newberry*.⁶⁴

Example. Jeb, a farmer, suffered an \$8,000 crop loss resulting from a drought. Jeb received an \$8,000 loan from the Farmers Home Administration (FHA), of which \$5,000 of the principal was immediately canceled. The amount of the canceled portion of the loan represents a replacement of a portion of the farmer’s lost profits, and must be taken into account in computing Jeb’s net earnings from self-employment.⁶⁵

Example. Fred was performing services as an independent contractor for a government agency. His contract was terminated after four years due to an act of war. He promptly accepted a position as an employee for a corporation after his contract was terminated. Eighteen months later, Fred was given an unexpected severance payment of \$1,000 to \$2,500 for each year of prior service. Although the IRS would likely view this as earned income because there was a previous nexus, the courts may be more lenient because Fred’s severance payment was not derived from a trade or business carried on. The “tax on self-employment income” imposed by IRC Section 1401, unlike the employment taxes imposed on wages in subtitle C, is technically an income tax because IRC Section 1401 is part of subtitle A of the Code.

Note. A partner’s compensation is deemed currently available on the last day of the partnership’s taxable year. Accordingly, an individual partner may not make a cash or deferred election with respect to compensation for a partnership taxable year after the last day of that year.⁶⁶

Periodic advances made by partners throughout the year, pursuant to an election of the partner, are *elective contributions*, assuming the plan otherwise satisfies the applicable requirements of the Code.⁶⁷

The definition of compensation for a self-employed person as determined in the plan document is extremely important in applying plan limitations and preventing discrimination. A plan may provide for employer contributions to be allocated to employees, including self-employed individuals, based on their compensation, including or excluding their elective contributions.

An erroneous calculation of earned income could result in the violation of various nondiscrimination rules or could cause the IRC Section 415 dollar or percentage limits on allowable contributions and benefits to be exceeded. A miscalculation could also result in operational discrimination in favor of HCEs and could jeopardize the tax-sanctioned status of the plan.

⁶¹ 76 TC 441, 444 (1981).

⁶² S Rept 1669, 81st Cong, 2d Sess (1950) (1950-2 CB 302, 354)

⁶³ *Newberry v. Commissioner* (76 TC 441, 444 (1981).

⁶⁴ Rev. Rul. 91-19 (1991-1 CB 186).

⁶⁵ Rev. Rul. 76-500 (1976-2 CB 254); see also Rev. Rul. 60-32 (1960-1 CB 23); Notice 87-26 (1987-1 CB 470).

⁶⁶ See Treas. Reg. Section 1.401(k)-1(a)(6)(ii)(B).

⁶⁷ Ltr. Rul. 200247052 (Aug. 28, 2002); see also Treas. Reg. Sections 1.401(k)-1(a)(3)(i), 1.401(k)-1(g)(3).

Even practitioners with a thorough understanding of how plan limits are applied and how earned income is figured will find the process of designing plans, calculating contributions, and applying limits a complex, nearly impossible task. It is difficult to design a plan around an owner because the owner's compensation fluctuates as the contribution amount is changed. Circular and interdependent calculations are required to solve for a particular result. Absent a legislative change, the practitioner must use caution. Spreadsheet software and programs offer a welcome solution for practitioners who need to design plans for owners of unincorporated businesses with common-law employees.

Self-Employment Losses

A self-employment loss from a separate unincorporated business that is unrelated to the employer adopting the plan, but is owned in part by the same individual does not directly offset the earned income of the employer adopting the plan. There is no such thing as negative compensation. Nevertheless, the loss will affect the calculation of the individual's self-employment tax, and the amount of that tax will have an effect on the calculation of earned income that can be considered for the plan.

Practice Pointer: Frequently, partners have different tax preparers. Information from the uncompleted federal income tax returns of some partners may be needed to compute the contributions to be made under the plan and to complete the federal income tax returns of the partnership, and in turn the individual federal income tax returns of the individual partners can be completed. Return preparation is much easier when all partners and the partnership have the same tax preparer; privacy issues are also minimized.

Determining Earned Income: Where to Start

Note. Unless otherwise indicated, line numbers in the section below are from the 2007 version of Form 1065.

Partners

There is no line number or amount on any tax return, worksheet, or schedule that can be used as the correct starting point for calculating a partner's preplan earned income or self-employment tax. It does seem prudent, however, to start with line 14 of Schedule K-1 to Form 1065, U.S. Return of Partnership Income. The amount entered is preceded by Code A (for net earnings/loss from self employment) or Code B (for gross farming or fishing income) or Code C (for gross-non-farm income). (Up to four adjustments are possible when using the amount from that line.) The amount on that line is initially determined using a worksheet (see below) provided in the instructions to Form 1065, and then is allocated to the individual partners. Thus, line 14 on Schedule K-1 of Form 1065 cannot always be determined simply by adding line 1 (ordinary income) and line 4 (guaranteed payments to partner) of Schedule K-1.⁶⁸ Payments made on the owner's behalf to a plan are reported on line 13 (Code R), "Other deductions."

Practice Pointer: If an individual's tax return is properly completed, line 14 on Schedule K-1 of Form 1065 is a suitable starting point for calculating earned income.

⁶⁸ See Form 1065 instructions and worksheet for Schedules K and K-1, lines 14 (see page 29).

Note. Similar rules apply to calculate self-employment income to electing large partnerships using Form 1065-B, Return of Income for Electing Large Partnerships, except that line 13a is the relevant starting point for Schedule K and box 9 for Schedule K-1 (of Form 1065-B). The Form 1065-B worksheet is similar, but not identical to the Form 1065 worksheet (see Form 1065-B, Instructions).

If there is an ordinary gain or loss on the sale of business property (from Form 4797 Part II, Sales of Business Property), the worksheet contained in the instructions to Form 1065 provides for included losses to be added back and included gains to be subtracted out before allocation to each partner. That adjustment (sometimes referred to as an “off-sheet” adjustment) appears in the instructions to Form 1065 but not on Schedule K or K-1. Its absence from Form 1065 (and its relevance to determining the correct amount on line 14) explains why line 14 of Schedule K-1 to Form 1065 cannot always be determined simply by adding line 1 (ordinary income) and line 4 (guaranteed payments to partner) of Schedule K-1.⁶⁹

See the “Worksheet for Calculating Ultra Net Earned Income.”

In addition to an adjustment for ordinary gains or losses on the sale of business property reflected on Schedule K-1, the instructions for Form 1065, Schedule K-1, line 14, provide for the amount on that line to be entered on Schedule SE to Form 1040 after three more off-sheet reductions are made (in addition to that for ordinary gains or losses on the sale of business property):

1. *IRC Section 179 expense deduction claimed.* Schedule K-1 shows only the IRC Section 179 deduction being passed through to the partner (line 12). The deduction actually claimed, however, is on Form 4562, Depreciation and Amortization, line 12. For example, if an individual is a partner in several partnerships, not all of the IRC Section 179 expenses may be deductible.
2. *Claimed unreimbursed partnership expenses.* Not all legitimate partnership expenses are run through the business. Such expenses, although not technically nonpassive losses, are reported on Form 1040, Schedule E, Supplemental Income and Loss, Part II, line 28(i). Unreimbursed partnership expenses that partners are required to pay under the terms of the partnership agreement are deductible.⁷⁰
3. *Depletion on oil and gas properties claimed.*⁷¹

Note. If the net earnings from self-employment from line 14 of a partner’s Schedule K-1 are reduced, the instructions for Schedule SE require an explanation to be attached.

Sole Proprietors

The calculation of a sole proprietor’s earned income starts with line 31 (“net profit or (loss)”) of Schedule C, Profit or Loss From Business (Sole Proprietorship), to Form 1040, although the amount that appears there will need to be adjusted slightly for the owner’s contribution and one-half of the self-employment tax deduction. That line is also reported on Form 1040, Schedule SE.

⁶⁹ L.C. Starr, ASPA, Eastern Regional Seminar, “Sole Proprietorship and Partnership Compensation and Deduction Issues” (audiotape) (1995).

⁷⁰ See Form 1040, Schedule E, Instructions to Parts II and III, Partnerships.

⁷¹ See Form 1065, Instructions, Adjustments, and Tax Preference Items.

Worksheet for Calculating Ultra-Net Earned Income

Following is a worksheet for calculating *ultra net* (after all adjustments) earned income under IRC Section 401(c)(2) for purposes of allocating contributions and calculating the employer's deduction and the amount of contributions that may be excluded from the employee's gross income.

Worksheet for Calculating Ultra Net Earned Income

1. Total earned income before any plan contributions (for 2007, Schedule K-1, line 14, plus partner's share of nonowner employee contributions shown on Form 1065, line 18)	\$ _____
2. Less any unreimbursed partnership expense claimed (data from the accountant or Form 1040, Schedule E, Part II, line 28, column (i)).....	-\$ _____
3. Less IRC Section 179 expense deduction claimed (see Schedule K-1, line 12, and confirm on Form 4562, line 12).....	-\$ _____
4. Less depletion claimed on oil and gas properties (see Schedule SE, Instructions, Partnership Income or Loss)	-\$ _____
5. Preplan compensation (items 1–4):	=\$ _____
<i>Sole Proprietorships, start here.</i>	
6. Less owner's share of common-law employee allocations (Form 1065, line 18, multiplied by partner's share percentage, or line 19 from Schedule C if self-employed)	-\$ _____
7. Net amount for determining Social Security in lieu of deduction under IRC Section 1402(a)(12) and Social Security tax (Items 5 and 6)	=\$ _____
8. Less half of Social Security tax deduction (if individual also has W-2 income, complete long Schedule SE to reflect the proper SE tax and in lieu of deduction).....	-\$ _____
9. Less elective and nonelective contributions for owner.....	\$ _____
10. Earned income for SEP exclusion purposes (Items 7–9; up to \$220,000 for 2006; \$225,000 for 2007).....	=\$ _____
11. Plus elective contributions of owner*	+\$ _____
12. Earned income for deduction purposes (not to exceed \$220,000 for 2006; \$225,000 for 2007).....	=\$ _____
13. Earned income for the allocation of plan contributions (Items 10 and 11 up to \$220,000 for 2006; \$225,000 for 2007)*	=\$ _____

* Not all plans provide for elective contributions to be included in the definition of earned income for the purpose of allocating employer contributions. For contribution allocation purposes after 1997, compensation generally may include elective contributions. For example, under a prototype SEP document, but not a model SEP document, elective contributions are treated as compensation for contribution allocation purposes.

Interests in Multiple Entities

If a self-employed individual has an interest in more than one entity, more than one entity may have to be considered in designing the plan, testing for various limits, and avoiding discrimination initially or in operation. The employers may be related or unrelated, or they may be considered related for some purposes but not all. For instance, if a sole proprietor has an interest in multiple related or controlled employers, in most cases, those employers will all adopt the plan. What if one of the entities was unrelated and did not adopt the plan? Would the deduction for half of the owner's self-employment tax have to be prorated? Possibly, says one commentator.⁷²

When the ultra net earned income is less than the maximum compensation cap (\$225,000 for 2007), the proration of the self-employment tax deduction among multiple entities (to increase the amount of earned income that is considered for plan purposes) would seem preferable to allocating all of the earned income to the entity that adopted the plan.⁷³ At the same time, it should be noted that allocating all of the self-employment tax to a nonadopting entity (to maximize the amount of earned income that is considered for plan purposes) might be considered aggressive.

Interaction With IRC Section 401(a)(17)

The recently issued proposed regulations state that a plan's definition of compensation used for applying IRC Section 415 cannot exceed the IRC Section 401(a)(17) limit—\$225,000 for 2007.⁷⁴ Many practitioners viewed this position as a departure from the generally accepted rule that section 415 compensation was not subject to the section 401(a)(17) compensation limit.⁷⁵ Arguably, once a participant has received \$225,000 (for 2007), they must cease making elective contributions for the remainder of that plan year even though their contributions were not in excess of the amounts permitted under the calendar year limits of IRC Section 401(g)—generally \$15,500; \$20,500 with catch-up contributions if age 50 or older. While the IRS chose to retain the rule from the proposed regulations, the final rules “grandfather” benefits accrued or payable under a plan as of the end of the limitation year immediately prior to the effective date of the final regulations. These benefits may be based on compensation in excess of the section 401(a)(17) compensation limit to the extent consistent with plan provisions that were adopted and in effect before April 5, 2007.⁷⁶ This provision should have no other effect in a defined contribution plan as the maximum \$45,000/\$50,000 annual addition limit under IRC Section 415 would already apply to a participant with compensation in excess of \$225,000 for 2007.⁷⁷

⁷² Lawrence Starr, ASPA, Eastern Regional Seminar, “Sole Proprietorship and Partnership Compensation and Deduction Issues” (audiotape) (1995).

⁷³ See Ann 94-101, Section 684, Exh I (1994-35 IRB 53).

⁷⁴ Prop. Treas. Reg. Sections 1.415(b)-1(a)(5), 1.415(c)-2(a).

⁷⁵ Treas. Reg. Section 1.415(c)-2(f).

⁷⁶ See, Preamble, Treas. Reg. Section 1.415; Treas. Reg. Section 1.415(c)-2(f).

⁷⁷ See Preamble, Treas. Reg. Section 1.415 (T.D. 9319, 2007-18 IRB 1041 (Apr. 30, 2007)); Treas. Reg. Section 1.415(c)-2(f).

Chapter 6

General Plan Design

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Plan Design begins with coverage requirements and then must follow a complex set of rules that create and maintain the qualified nature of the plan. A qualified plan has the tax deduction advantages for the business entity and/or the individual. There are several qualification requirements unique to defined contribution plans (that is, money-purchase pension plans or profit-sharing plans or stock bonus plans) and others that are unique to defined benefit plans. This chapter discusses these requirements and then provides examples on how the requirements can be used to solve the business issues.

The ABC's of Qualified Plan Design: Adequacy, Budget, and Cost

The first question that needs to be addressed is, "What is the reason for this plan?" If the plan is for retirement for the employees then replacement ratios should be established targeting the desired amount of pensions to be provided. The demographics of the organization often drive the design of the plan.

If the plan revolves around the tax savings to the owner, then the greatest disparity between owners and key employees and the rank and file may be the target. Here, adequacy may be that the tax savings must be greater than the cost for the rank and file. If an owner with a 40 percent state and federal combined tax rate wishes to contribute \$40,000 towards retirement and the staff cost exceeds \$16,000, then the tax savings may not be sufficient to justify the plan. That owner can obtain favorable capital gains and dividend income or income from tax free municipal bonds if taxable income is taken instead and money is invested after tax. If the contribution is made to the plan, the income earned on the \$40,000 contribution is tax deferred but taxed at ordinary income at the time of distribution.

The budget for the rank and file and the owners needs to be determined. In the small plan market, if the "Key Employees"¹ cumulative account balances exceed 60 percent of the total for the plan (with some adjustments)², the plan would be top heavy and the employer is required to make a contribution that is the lesser of 3 percent of compensation for each eligible employee (or only non key employees if the plan is written as such) or the percentage of the contribution allocated to any Key Employee. When designing a plan, the amount designated for each employee or job class for each employee group should be determined first.

This budget dictates the type of plan to be used. As an example, if the owners of the business wish to contribute in excess of the Section 415 limit for defined contribution plans (\$45,000 in 2007 without the 401(k) catch-up), the only qualified retirement program that meets the requirement is a defined benefit plan. If a privately owned company wishes to establish a qualified retirement program for the company with no employer contributions, then the only plan available is an employee-pay-all 401(k) plan.

The cost of delivery of the benefits must also be considered. In order to reduce high staff costs, a law firm may want to have the associates in a separate employee-pay-all 401(k) plan and as long as they meet the proper coverage requirements, the discrimination testing and contribution allocations may be separated. This would necessitate the cost of establishing and maintaining two plans but the savings may be cost justified.

To measure benefit adequacy, the concept of replacement ratios is used. The benefits are projected to some selected date, usually the normal retirement date. This benefit is added to a projected Social Security Primary Insurance Amount (SSPIA) and the sum is then divided by the anticipated compensation amount at retirement age. This produces a percentage of the final average earnings that is referred to as the replacement ratio. Taking selected employees from different age and wage demographics, allows the business to establish a reasonable retirement benefit for the employees.

The employer can determine the amount of targeted replacement ratios based upon years of service, compensation or strategic importance to the organization. Once the replacement ratio is determined, the employer can then make assumptions as to who will pay for that level of benefits. As an example, if the average cost for a 75 percent replacement ratio was 8 percent of pay, an employer may indicate that it expects the employees to pay for a portion of the amount. This would indicate that an employer contribution of 3 percent, with an expected employee contribution of 3 percent would meet the target. To encourage the employee to pay that portion, a matching contribution of 66 percent for each dollar the employee contributes would be made up to 3 percent of pay.

Higher income earners often have a gap in qualified plans because income that can be used for contribution and discrimination testing is limited. The limit is increased each year with cost of living increases, and in 2007, the limit is \$225,000.³ If the executive's compensation is \$400,000, then \$175,000 is not used in computing contribution amounts and the 401(k) contributions are less a percentage of total compensation. In addition, the executive is earning far in excess of the Taxable Wage Base (\$97,500 in 2007) so most of compensation is not considered for the Social SSPIA. Lower income earners have a higher percentage of their pay that is replaced with the SSPIA. This would require an additional non-qualified plan for the executive to maintain the targeted replacement ratio percentage.

¹ IRC Section 416i(1)(A).

² IRC Section 416(g).

³ IRC Section 401(a)(17).

Defined Contribution Plan Requirements

A Defined Contribution Plan:

- Must require separate accounting for each employee's accrued benefit.⁴
- May not exclude employees who are beyond a specified age.⁵
- Must contain the limitation on annual additions than can be allocated to a participant's account or accounts under an employer's defined contribution plan or plans. In general, the amount that may be allocated to a participant's account in a defined contribution plan may not exceed the lesser of (a) 100 percent of a participant's compensation or (b) \$45,000 (the 2007 limits), plus catch-up contributions for participants over age 50 if permitted under the plan.⁶
- Must provide for the allocation of contributions and trust earnings to participants in accordance with a definite formula.⁷
- Must provide for distributions in accordance with an amount stated or ascertainable and credited to the participant's account(s).⁸
- Must value the investments held under the trust, at least once a year, on a specified inventory date, in accordance with a method consistently followed and uniformly applied.⁹ This requirement may, however, be satisfied in a plan in which contributions are invested solely in insurance contracts or in mutual fund shares even if there is no provision in the plan for periodic valuation of assets.¹⁰
- Must designate whether it is a money-purchase pension plan or a profit-sharing plan.¹¹

Target benefit plans, in which the actual pension is based on the amount in the participant's account, are treated as defined contribution plans. Hybrid plans which are part target and part defined benefit be treated as defined contribution to the extent that benefits are based on the individual account.¹²

Allocation of Expenses

A defined contribution plan is permitted to charge the accounts of former employees that do not take an available distribution for their share of the plan's administrative expenses, even though the employer pays the expenses associated with the accounts of the active employees.¹³

In a 2004 revenue ruling,¹⁴ the IRS held that a defined contribution plan may charge a pro rata share of reasonable administrative fees to a terminated vested participant who does not take an available distribution. This ruling clears up the uncertainty caused by the Department of Labor's (DOL) approval of such action in Field Assistance Bulletin 2003-3 without the IRS issuing any guidance supporting the DOL position. The IRS decided that charging administrative fees to terminated vested employees while not assessing such fees

⁴ IRC Section 411(b)(2).

⁵ IRC Section 410(a)(3).

⁶ IRC Section 415(c)(1).

⁷ Treas. Reg. Section 1.401 1(a)(2)(ii), 1.401 1(b)(1)(i).

⁸ Rev. Rul. 70 125 (1970 1 C.B. 87).

⁹ Rev. Rul. 80 155 (1980 1 CB 84).

¹⁰ Rev. Ruls. 73 435 (1973 2 CB 126), 73 554 (1973 2 CB 130).

¹¹ IRC Section 401(a)(27)(B); Rev. Rul. 94 76 (1994 2 CB 46).

¹² Announcement 95 33 (1995 19 IRB. 14).

¹³ Rev. Rul. 2004 10 (2004 10 IRB 484). It is not treated as a "significant detriment," see Treas. Reg. Section 1.411(a) 11(c)(2)(i).

¹⁴ Rev. Rul. 2004 10 (2004 10 IRB 484).

on active employees does not impose a significant detriment on the exercise of participants' rights, and, therefore, was not a violation of the vesting rules.

The IRS reasoned that if the terminated vested employee rolled over a distribution into an individual retirement account or annuity (IRA), he or she would probably incur administrative expenses from the IRA trustee or custodian. Thus, the IRS concluded that charging employees for leaving their accounts in the plan does not impose any significant additional cost.

Caution: *The ruling provides no guidance on the allocation of expenses in the case in which a participant does not have the option to receive a lump sum.*

The IRS ruling specifically approves of an allocation that is based on multiplying the ratio of the individual participant's account balance to all account balances by the appropriate administrative charges. The ruling also states that other allocation methods that would directly charge the administrative costs associated with the terminated participant's vested accounts would be acceptable, but it did not endorse any particular method. In addition, and in accordance with the DOL guidance¹⁵ Field Assistance Bulletin 2003-3, the expenses charged must be plan administrative expenses and not expenses associated with redesigning the plan.

The IRS also cautioned that the policy of charging terminated vested employees is subject to the general nondiscrimination rules that require similar treatment for both highly compensated employees (HCEs) and nonhighly compensated employees (NHCEs).

Whatever policy is adopted by the plan's sponsor, the plan document, summary plan description (SPD), and other communication materials should accurately reflect the policy. Depending on the number of terminated vested employees that still maintain accounts within the plan, some savings could result for the employer by charging them reasonable administrative fees, even though the employer picks up the expenses associated with active employees. If a decision is made to charge such administrative fees, other communication materials given to participants should be revised accordingly.

Plan Types

There are a number of plan types, including profit-sharing plans, stock bonus plans, savings and thrift plans, 401(k) plans, employee stock ownership plans (ESOP), pension plans, target benefit plans, 412(i) plans, and cash balance plans. Each is discussed in the following sections.

Profit-Sharing Plans

Profit-sharing is really a misnomer in the new pension environment. Not for profit companies can sponsor these plans. Companies can make a contribution and not have a profit. These programs are more like discretionary plans. A 401(k) plan, must at its core, be a profit-sharing plan and the contributions can be discretionary for both employees and the employer. A profit-sharing plan need not provide a definite, predetermined formula for determining the amount of contributions to be made. However, there must be recurring and substantial contributions, and contributions must not be made at such times and in such amounts that the plan in operation discriminates in favor of HCEs.¹⁶

¹⁵ Rev. Rul. 2004 10 (2004 10 IRB 484).

¹⁶ Treas. Reg. Section 1.401 1(b)(1)(ii).

An important requirement, however, is that a profit-sharing plan must provide a definite, predetermined formula for allocating the contributions among the participants, and for distributing the accumulated funds to the employees, for instance, after a fixed number of years (at least two), the attainment of a stated age, or upon prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. The allocation formula is generally related to compensation, although age, service, and other factors may be given consideration. A profit-sharing plan may use funds in an employee's account to provide incidental life or health insurance for the employee and/or the employee's family.¹⁷ A profit-sharing plan may even purchase incidental joint and survivor life insurance on the life of a participant and a member of the participant's family, and the plan may provide that the trustee is to distribute, or sell for its fair market value (FMV), the policy to the participant upon the death of non-participant beneficiary while the participant is employed.¹⁸ A proposed amendment to the exemption would allow the sale of a policy by a plan, to a personal or private trust for the participant or a relative.¹⁹

Example. A profit-sharing plan provides that funds accumulated for a 2-year period will be distributed to participants upon the attainment of age 40. The provision is allowable in a profit-sharing plan. Unless an exception applies, distributions prior to age 59½ may be subject to a 10 percent premature distribution tax penalty.

A tax exempt nonprofit charitable organization may maintain a profit-sharing plan and if not a state or local government employer, the plan may include a cash or deferred arrangement, such as a 401(k) plan.²⁰

Stock Bonus Plans

A stock bonus plan is similar to and provides benefits similar to those of a profit-sharing plan, except that benefits are distributable in stock of the employer. The employer contributions are not necessarily dependent on profits. Generally, the IRS has taken the position that distributions must be in the form of employer stock, except for the value of a fractional share, and at least one court agrees.²¹

However, a stock bonus plan may provide for the payment of benefits in cash if certain conditions are met. A stock bonus plan (or an ESOP) generally is required to give participants the right to demand benefits in the form of employer securities, and if employer securities are not readily tradable on an established market, the participant generally must have the right to require the employer (not the plan) to repurchase employer securities under a fair valuation formula (called a put option).²² The put option must be available for at least 60 days following distribution of the stock and, if not exercised within that time, for another 60 day (minimum) period in the following year. The plan may repurchase the stock instead of the employer, but may not be required to do so. Banks prohibited by law from redeeming or purchasing their own shares are excused from the requirement that they give participants a put option.²³

¹⁷ Treas. Reg. Section 1.401 1(b)(1)(ii); Rev. Ruls. 68 24 (1968 1 CB 150), 69 414 (1969 2 CB 59), 71 295 (1971 2 CB 184).

¹⁸ See ERISA Section 3(15); IRC § 4975(e)(6); PTCE 92 6 (57 FR 5189); DOL Op. Ltr. 98 07A.

¹⁹ See 67 FR 31835, which would be retroactive to February 12, 1992, if adopted.

²⁰ IRC Section 401(k)(4)(B); GCM 38283 (2 15 80).

²¹ Rev. Rul. 71 256 (1971 1 CB 118); Miller v. Comm., 76 TC 433 (1981).

²² IRC Section 409(h), 409(h)(7), 409(h)(2)(B).

²³ IRC Section 409(h)(3) and (4).

A stock bonus plan must also pass through certain voting rights to participants or beneficiaries. If the employer's securities are registration type,²⁴ each participant (or beneficiary if applicable) must be entitled to direct the plan as to how securities acquired after 1979 and allocated to the participant are to be voted.²⁵ Special rules apply to securities that are not registration type.²⁶

Savings and Thrift Plans

Savings and thrift plans are defined contribution plans in which employee contributions generally make up a relatively large part of total contributions. The Internal Revenue Code (IRC or the Code) makes no specific provision for these plans, but they may be tax qualified if they meet the requirements for a pension, profit-sharing, or stock bonus plan. A savings or thrift plan may qualify as a pension plan (for example, a money-purchase plan) unless there are preretirement privileges to withdraw benefits. Frequently, they are established as profit-sharing plans by providing for employer contributions out of current or accumulated profits.

401(k) Plans

A 401(k) plan generally is a profit-sharing plan or stock bonus plan which provides for contributions to be made pursuant to a cash or deferred arrangement (CODA), under which individual participants elect to take amounts in cash or to have the amounts deferred under the plan. Under a traditional 401(k) plan, amounts deferred under this election, including catch up contributions, are excluded from a participant's gross income for the year of the deferral and treated as employer contributions to the plan for various purposes.²⁷ Effective in 2006, employers can now offer Roth 401(k) plans for their employees. A Roth 401(k) provides for after tax employee contributions, but accumulates tax free. The decision to have 401(k) contributions made on a traditional pre tax basis or the new Roth 401(k) basis, is solely at the discretion of the employee if the option is provided.

In determining the best option to select, the employee should consider whether they will be at a higher tax rate at retirement than while working. For high income earners with adequate retirement savings who expect higher tax rates in the future and young employees who expect much higher earnings in the future, the Roth option will provide greater benefits.

If the Roth 401(k) account balance is rolled over to a Roth IRA prior to any required distribution date, the age 70½ distributions can be avoided since they are not required in a Roth IRA. This allows the participant to delay any distributions and maintain the tax free accumulations until death. If young beneficiaries are designated, then the tax free accumulations can continue for many years.

A 401(k) plan may provide that all employer contributions are made pursuant to an employee's election to defer or may provide that the cash or deferred arrangement is in addition to employer derived contributions. Typically, the employer contributions are in the form of a percentage match for each dollar deferred by an employee. In either case, the top heavy rules generally apply.

Employers without employees may find a 401(k) plan extremely attractive. 25 percent of preplan compensation, plus elective contributions, may be contributed and deducted up to \$45,000 (for 2007, \$50,000 with catch up contributions).

²⁴ That is, if they must be registered under Section 12 of the Securities and Exchange Act of 1934 or would be required to be registered except for an exemption in that Act; See the Securities and Exchange Act of 1934, Section 12(g)(2)(H)).

²⁵ IRC Sections 401(a)(28), 4975(e)(7), 409(e)(2).

²⁶ IRC Sections 401(a)(22), 409(e)(3), 409(e)(5).

²⁷ Treas. Reg. Section 1.401(k)-1(a)(4)(ii), 1.401(k)-1(a)(4)(iii).

Example. Yetta Bow Corporation maintains a qualified 401(k) profit-sharing plan and makes the maximum contribution. Yetta, age 40, earned \$100,000 and elected to defer \$15,500. She is the only participant, so the ADP discrimination tests do not apply. The corporation may deduct \$40,500 ($(\$100,000 \times .25) + \$15,500$). If Yetta were age 50 or older, her maximum total deductible contribution would be \$45,500 ($\$25,000 + \$15,500 + \$5,000$).

Example. Same facts as in the preceding example, except Yetta earns \$118,000. \$45,000 may be contributed (meaning, $[\$118,000 \times .25] + \$15,500$ may be contributed and deducted by Yetta Bow). If Yetta were over age 49, she could receive a total deductible contribution of \$50,000 ($\$29,500 + \$15,500 + \$5,000$).

There are now two types of Safe Harbor 401(k) plans as noted in Chapter 8, “Internal Revenue Code Section 401(k) and Safe-Harbor 401(k) Plan Design”. These programs are allowed under Section 401(k) 12 of the Code. The two methods are a 3 percent nonelective contribution to be made to all eligible employees or the Safe Harbor Match which matches participants 100 percent for each dollar they contribute as an elective contribution up to 3 percent of compensation and 50 percent for each dollar they contribute of the next 2 percent for an additional 1 percent of compensation. The plan can provide up to a 100 percent match up to 6 percent of compensation and still fall under the safe harbor matching plan.

The use of the 3 percent nonelective or the Safe Harbor Match is dependent upon the demographics of the organization and any additional amounts that the employer may want to contribute to the plan. In general, if the employer has few employees contributing to the plan and would like to benefit the HCEs at minimal cost, then the Safe Harbor Match works better. If the HCE group is young on average compared to the NHCEs, and the employer wishes to make additional contributions to the plan using permitted disparity (See Chapter 7, “Permitted Disparity—Integration of Contributions”), then the Safe Harbor Match option is better.

If the demographics were slightly different, all the NHCE wanted to defer, the owner was at least 7 to 10 years older than the NHCEs on average, and the owner wanted to maximize her contribution with the minimum amount to the staff, (taking a Gateway contribution into consideration (see Chapter 9, “Defined Contribution Cross-Tested, General Tested Plan Design”), then the 3 percent nonelective safe harbor would be the better alternative.

Employee Stock Ownership Plan (ESOP)

An Employee Stock Ownership Plan (ESOP) is a defined contribution plan that must be a qualified stock bonus plan or a qualified stock bonus plan and a qualified money-purchase pension plan.²⁸

An ESOP must be designed to invest primarily in qualifying employer securities.²⁹ Qualifying employer securities are shares of common stock issued by the employer (or a member of the same controlled group) (a) readily tradable on an established securities market, or, (b) in case there is no such readily tradable stock, having a combination of voting power and dividend rights at least equal to the class of common stock having the greatest voting power and the class of common stock having the greatest dividend rights. Noncallable preferred shares qualify also, if they are convertible into stock meeting the requirements of items a or b (as appropriate) and if the conversion price is reasonable at the time the shares are acquired by the plan.³⁰ In a General Counsel Memorandum, the IRS determined that the common stock of a corporation did not constitute employer securities with respect to the employees of a partnership owned by the corporation’s subsidiary,

²⁸ IRC Section 4975(e)(7); ERISA Section 407(c)(6).

²⁹ IRC Section 4975(e)(7).

³⁰ IRC Sections 4975(e)(8), 409(l).

because a partnership is not a corporate entity. As a result, the employees of the partnership could not participate in the corporation's ESOP.³¹

The previous tax benefits of an ESOP that was made available to S Corporations is no longer available.

An ESOP may offer some significant tax advantages not available in other plan types, namely:

1. Certain loan transactions, including a loan guarantee, between the plan and the employer are exempt from the prohibited.
2. Certain forfeitures and contributions are excluded from the annual additions limit.
3. Transaction rules which prohibit loans between plans and parties in interest.³²
4. Increased deductions by a C corporation employer are permitted on loan repayments.³³
5. Long term capital gain on the sale of qualified securities³⁴ may be deferred by purchasing replacement securities within a replacement period that begins three months before the date of sale to the ESOP and ending 12 months after the sale.³⁵
6. Exemptions apply in financing the acquisition of another company.
7. Presumably, though not always, ESOP's place stock in friendly hands.³⁶
8. Advantages apply if the ESOP is used as an estate planning tool. The FMV of stock acquired by ESOP before death can be more easily determined, possibly reducing the chances of dispute with IRS. Purchase of shares from estate when the benefits of an IRS Section 303 redemption are not available, may result in no gain. Generally, the basis of the sold shares will equal the FMV on the date of death, and the purchase price paid (by corporation or ESOP) will likely be this amount.³⁷
9. ESOP's may provide a market for the securities of the controlling owner of a closely held corporation.

Pension Plans

A pension plan is established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement.³⁸ Thus, a pension plan may not permit the withdrawal of employer contributions or earnings thereon, even in the case of financial need, before death, disability, retirement, severance of employment, or termination of the plan.³⁹ However, withdrawals may be permitted once the employee has reached normal retirement age even if the employee has not actually retired.⁴⁰

³¹ General Counsel Memorandum (GCM) 39880 (10 8 92).

³² IRC Section 4975(d)(3); ERISA § 408(b)(3).

³³ IRC Sections 404(a)(9)(c), 404(k).

³⁴ IRC Sections 1042(b)(4), 1042(c)(1); Ltr. Ruls. 9830028 (Apr. 28, 1998), 921506 (Jan. 9, 1992), 9036039 (Jun. 13, 1990), but see, Ltr. Ruls. 200052014 (Jan 27, 2002, released Dec. 29, 2002) and 8910067 (Dec. 14, 1988) regarding stock not readily tradable (NASD pink sheet; over the counter securities (OTCBB)).

³⁵ IRC Section 1042(c); Temp. Treas. Reg. _ 1.1042 1T, Q&A 3(c).

³⁶ NCR Corp v. AT&T, 761 F. Supp 475 (SD Ohio 1991); Menowitz v. NCR Corp, No. C 3 91 12 (SD Oh1991).

³⁷ IRC Section 302, 303, 1014, 6166.

³⁸ Treas. Reg. Section 1.401 1(b)(1)(i).

³⁹ Rev. Ruls. 69 277 (1969 1 CB 116), 74 417 (1974 2 CB 131).

⁴⁰ Rev. Rul. 71 24 (1971 1 CB 114), 73 448 (1973 2 CB 136).

For the same reasons, a pension plan may not permit the withdrawal of mandatory employee contributions or employee contributions to which employer contributions are geared (as in a hybrid money-purchase thrift plan) before retirement.⁴¹ A pension plan may also permit an employee to withdraw nondeductible voluntary contributions without terminating membership in the plan, provided the withdrawal will not affect the member's participation in the plan, the employer's past or future contributions on the employee's behalf, or the basic benefits provided by both the participant's and the employer's compulsory contributions.⁴²

The requirement that the benefits be definitely determinable may be satisfied by providing for either fixed benefits (as a defined benefit pension plan) or fixed contributions (as in some defined contribution plans).

Under a defined benefit plan which provides fixed benefits, the size of the pension, or a formula to determine the pension amount, is set in advance. Annual contributions are determined by actuarial methods that will gradually accumulate a fund sufficient to provide those benefits when each employee's pension is due, generally at retirement. The benefit amount or formula is generally related to compensation, years of service, or both.

Under a plan that provides for fixed contributions, such as a defined contribution money-purchase pension plan, the annual contribution to an employee's account is fixed or definitely determinable, and the employee receives the funds accumulated in his or her account or whatever benefit can be purchased with those funds. Defined contribution plans have individual accounts established for each participant that reflect their individual beneficial interests under the plan. The fixed contribution may not be geared to profits and is generally expressed as a percentage of each employee's compensation not in excess of \$225,000 (the 2007 limit).⁴³

A plan is not a pension plan if it provides for layoff, sickness, accident, hospitalization, or medical expenses (except medical expense benefits for retired employees). However, a pension plan may provide incidental death benefits, through life insurance or otherwise.⁴⁴

Normal Retirement Age

The normal retirement age in a defined benefit pension or annuity plan is the lowest age specified in the plan at which the employee has the right to retire without the consent of the employer and receive retirement benefits based on service to date of retirement at the full rate set forth in the plan (that is, without actuarial or similar reduction because of retirement before some later specified age). Ordinarily, the normal retirement age under a defined benefit pension and annuity plans is age 65, but a pension plan may provide for a normal retirement age of any age less than 65. If normal retirement age is less than age 62, and benefits begin before that age, the annual defined benefit dollar limit (\$180,000 for 2007) must be actuarially reduced.⁴⁵ Furthermore, it is required that the accrued benefit of an employee who retires after normal retirement age be actuarially increased to take into account any period after age in which the employee was not receiving any benefits under the defined benefit plan unless the plan allows for and provides notification to the participant for the suspension of benefits.⁴⁶ However, a pension plan may permit early retirement, and any reasonable optional early retirement age will generally be acceptable. Although a pension plan must provide primarily retirement benefits, a plan could provide for a lump sum distribution to an employee who has reached both 59½

⁴¹ Rev. Ruls. 56 693 (1956 2 CB 282), 74 417 (1974 2 CB 131).

⁴² Rev. Rul. 60 323 (1960 2 CB 148), 69 277 (1969 1 CB 116).

⁴³ Treas. Reg. Section 1.401 1(a)(2)(i).

⁴⁴ IRC Section 401(h); Treas. Regs. Sections 1.401 1(a)(2)(i), 1.401 1(b)(1)(i), 1.401 14.

⁴⁵ IRC Section 415(b)(2)(C).

⁴⁶ IRC Section 401(a)(9)(C)(ii); see guidance in Temp. Treas. Reg. Section 1.401(a)(9) 6T, A 7.

and the plan's normal retirement age, even if he continues to work for the employer.⁴⁷ Furthermore, a pension plan may provide for payment of the balance to the credit of an employee on plan termination.⁴⁸

The significant advantage of a defined benefit plan in the micro business market is the allowance of catch up retirement contributions for those who may not have saved enough towards their retirement during the early working years. The amounts of the contributions can exceed the defined contribution amounts and depending upon the attained age and anticipated retirement of the participant, the tax deductible contributions from earned income or W-2 wages can be in excess of \$200,000. A tabular array of various compensation and ages indicates sample contribution levels in the first year of the defined benefit plan.

For the 2007 Calendar Year, the estimated deductible contributions to a defined benefit plan are as follows:

Contributions (funded from Entry Age to Retirement Age using the Mortality Table in 2001-62 & 5.5 percent interest pre- and post-retirement):

Entry Age	Retirement Age	<i>Highest 3 Year Average Compensation</i>			
		\$50,000	\$100,000	\$150,000	\$218,333+
35	55	\$18,798	\$ 40,834	\$ 44,290	\$ 44,290
40	55	\$29,250	\$ 58,499	\$ 63,450	\$ 63,450
45	55	\$50,907	\$101,814	\$110,430	\$110,430
50	62	\$35,063	\$ 70,126	\$105,189	\$126,227
55	62	\$69,498	\$138,995	\$175,134	\$175,134
60	65	\$96,070	\$172,926	\$172,926	\$172,926
65	70	\$84,038	\$168,077	\$226,007	\$226,007

Example: Bob has the following criteria:

AGE:	55
CURRENT INCOME:	More than the lifestyle needs; over \$500,000
TAXATION:	Losing deductions since house mortgage is low or non existent Paying too much!
KIDS EDUCATION:	Completed or already covered
RETIREMENT SAVINGS:	Low and wants to make sure that there's no chance of running out of money
INVESTMENT PROFILE:	Conservative to moderate
EMPLOYEES:	None or just a few

⁴⁷ Treas. Reg. Section 1.401 1(b)(1); Ltr. Rul. 7740031 (Jul 11, 1977).

⁴⁸ IRC Section 401(a)(20).

Solution: Since the objective for this client is tax driven, a defined benefit pension plan and a 401(k) profit-sharing plan would be ideal for this individual. The defined benefit plan would provide a deductible contribution of approximately \$175,134. A 401(k) plan would provide an additional \$20,500 contribution and the Pension Protection Act of 2006 allows for a 6 percent of pay employer contribution of \$13,500 (\$225,000 times 6 percent) for a total deductible contribution of \$209,134.

Target Benefit Plans

A target benefit plan is a money-purchase pension plan under which contributions to an employee's account are determined by reference to the amounts necessary to fund the employee's stated benefit under the plan.⁴⁹ Under a target plan, allocations are generally weighted for age, and, in some cases, age and compensation.

Although a target benefit plan is a type of defined contribution plan, as a pension plan it is subject to the minimum funding requirements of IRC Section 412. Safe harbor requirements for target plans are set forth in the cross-testing regulations under IRC Section 401(a)(4), under which a target plan will be deemed to be nondiscriminatory.⁵⁰ Most target benefit plans have been replaced by the more flexible age weighted profit-sharing allocations. Target benefit plans are more often used in not-for-profit organizations where each year's contribution will not be determined by a rotating, volunteer board of directors but will be provided as a predetermined retirement benefit for the employees.

412(i) Plans

A 412(i) plan, or fully insured plan, is a defined benefit plan that is exclusively funded with guaranteed investment contracts, retirement income annuities, and some forms of life insurance. If the contracts meet certain requirements, the plan will be exempt from the minimum funding requirements, quarterly contributions, and the actuarial statement, Form 5500, Schedule B. Underfunding is not an option and level annual premium payments must continue to the participant's retirement date. Because of lower rates of return, IRC Section 412(i) plans are front loaded, and deduction amounts for a given benefit are higher, compensating, in part, for a less than market rate of return. IRC Section 412(i) plans are more fully discussed in Chapter 11, "Fully Insured Defined Benefit Plans—Internal Revenue Code Section 412(i)."

It has been stated that the "412(i)—the good plan with the bad reputation—can do a lot for a smaller business owner's retirement package, but make sure they know what it shouldn't do."⁵¹ Recent IRS guidance clarifies the types of contracts that are treated as abusive and their identification as a "possible listed transaction." The ideal candidate would be a self employed individual, age 50 to 55, with few, if any, employees.

A qualified pension plan will not satisfy the requirements for an IRC Section 412(i) plan if it holds life insurance and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant's benefits at normal retirement age under the terms of the plan. Further, employer contributions under a qualified defined benefit plan that are used to purchase life insurance coverage for a participant in excess of that party's death benefit under the plan are not fully deductible when contributed. Instead, they are carried over to be treated as contributions in future years and deductible in future years when other plan contributions that are taken into account for the tax year are less than the maximum amount deductible for the year pursuant to the limits of IRC Section 404.

⁴⁹ Treas. Reg. Section 1.401(a)(4) 8(b)(3)(i).

⁵⁰ Treas. Reg. Section 1.401(a)(4) 8(b)(3); Prop. Treas. Reg. Section 1.411(b) 2(c)(3)(iii).

⁵¹ Gregory Taggart, "Using and Abusing the 412(i)," *Bloomberg Wealth Manager*, p 65 (January 2004).

Such transactions have been identified as “listed transactions” effective February 13, 2004, provided that the employer deducted premiums paid on a contract for a participant with a death benefit that exceeds the participant’s plan death benefit by more than \$100,000.⁵²

The IRS has made it clear that a 412(i) plan cannot use differences in life insurance contracts to discriminate in favor of HCEs. A plan that is funded, in whole or in part, with life insurance contracts will not satisfy the IRC Section 401(a)(4) nondiscrimination rules if:⁵³

1. The plan permits HCEs to purchase those life insurance contracts at cash surrender value prior to the distribution of retirement benefits.
2. Any rights under the plan for NHCEs to purchase life insurance contracts from the plan prior to distribution of retirement benefits are not of inherently equal or greater value than the purchase rights of HCEs.

The IRS also warned that future guidance will limit the use of what it views as aggressive funding tactics. Characteristics of plans that the IRS views as abusive include unusually high expense loads and unusually low cash values in early policy years, resulting in high death benefits based on these values. These arrangements conclude with a contract loan or distribution sometime after the first five policy years, followed by a sharp increase in the policy cash value. The IRS has expressed the opinion informally that such arrangements are abusive, and that future guidance is expected to apply retroactively.

Practice Pointer: Arrangements have been promoted in which an employer establishes a 412(i) plan under which the deductible employer contributions are used to purchase a specially designed life insurance contract. Generally, these special policies are made available only to HCEs. The insurance contract is designed so that the cash surrender value is temporarily depressed, so that it is significantly below the premiums paid. The contract is distributed or sold to the employee for the amount of the current cash surrender value during the period the cash surrender value is depressed; however, the contract is structured so that the cash surrender value increases significantly after it is transferred to the employee. Use of this springing cash-value life insurance gives employers tax deductions for amounts far in excess of what the employee recognizes in income. See the discussion of FMV that prevents taxpayers from using artificial devices to understate the value of a life insurance contract.

Cash Balance Plans

A cash balance plan is a defined benefit plan that calculates benefits in a manner similar to defined contribution plans. It resembles a defined contribution plan in that each employee has a hypothetical account or cash balance to which contributions and interest payments are credited.

Nevertheless, because, the actual funds are pooled, participant direction is not possible. Like other plans of the defined benefit type, the employer bears both the risk and the benefits of investment performance.

Like other defined benefit plans, a cash balance plan defines an employee’s retirement benefit by a formula, and the employee’s retirement benefit does not depend either on the employer’s contributions to the plan or on the investment performance of the plan’s assets, as it would in a defined contribution plan. A cash balance plan defines an employee’s benefit as the amount credited to an account, while other defined benefit plans typically define an employee’s benefit as a series of monthly payments.

⁵² Rev. Rul. 2004 20 (2004 10 IRB 546), modifying and superseding Rev. Rul. 55 748 (1955 2 CB 234).

⁵³ Rev. Rul. 2004 21 (2004 10 IRB 544).

There are two distinct advantages to a cash balance plan. The first is that the value of the benefits as participants near retirement age remain stable as either a flat percentage of compensation or a flat dollar amount. As an example, the benefit may be defined as 7.5 percent of compensation or \$1800. The second advantage is that the formula is easy to understand.

The Pension Protection Act of 2006 provided relief for new cash balance plans. The law indicated that the plan's benefits would not be age discriminatory. Existing defined benefit plans that convert to a cash balance arrangements, must convert using an A + B method, that is, the benefit accrued to date (A) is frozen and may be converted into a cash balance amount and new benefits (B) are an add on to the original benefit.

Many existing cash balance plans were converted from traditional defined benefit plans and had wear away provisions that indicated that until the benefits under the cash balance plan "wore away" or were greater than the value of the former benefit structure, no additional benefits would be earned. These plans are currently in limbo and the IRS will be reviewing these individually as they are processed for their application for a favorable determination letter.

New cash balance plans are anticipated to flourish over the next several years.

Floor Offset Plans

Floor offset plans are a special combination of defined benefit and defined contribution plans. In these arrangements, amounts contributed in the defined contribution plan are projected to retirement age to determine a theoretical benefit at retirement. This benefit is subtracted from the benefit determined under the defined benefit plan. If the theoretical benefit from the projected defined contribution amounts is greater than or equal to the defined benefit amount, then the participant does not receive a benefit from the defined benefit plan. If the amount from the defined benefit plan is greater, then the participant obtains two benefits, one from the defined contribution plan and a remaining benefit from the defined benefit plan.

In order to illustrate the power of this design, following is a fact pattern in which this design worked. There are multiple uses for this design and the flexibility is such that each owner or HCE can be in their own benefit group.

Example. A successful accounting practice desires to maintain its viability as an on going enterprise in the future. The younger accountants need to provide a buyout for the senior partners who were the visionaries of the practice. They do not want to strap the practice for future generations and would like a mechanism that may work for them too.

The senior partners, each owning 6 percent of the practice, are willing to give up some current income for the security of a pre-funded arrangement that would be protected from bankruptcy, and they could have flexibility on the distributions upon retirement.

Both parties understand that they have passed through earnings in the past, so there is no "significant capital account" that would be subject to a capital gains tax rate.

The practice had a safe harbor, 401(k), cross tested profit-sharing plan, that in 2007, would provide a \$50,000 contribution to the partners age 50 and over and \$45,000 for those partners under age 50.

The practice has made significant annual contributions to the staff, and is willing to continue to increase the staff cost to accomplish their goals if the cost is not prohibitive.

Solution. The following two charts show a group that fits the profile of the previous example. The first illustration is using a flat dollar allocation regardless of age. We would use this if the practice was an "equal share" practice.

The second illustration is done using an age weighted allocation. Those that are closer to retirement age receive a greater contribution since we are funding the same accumulation amount over a shorter period.

A Floor Offset, Cash Balance Plan Using a Flat Dollar Allocation Regardless of Age

Ownership %	Age	Estimated 2006 Plan Compensation	401(k) with Catch up	Profit-Sharing	DB "Cash Balance" Accrual	DB + Profit-Sharing	DB + Profit-Sharing + 401(k)
6.00%	56	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	51	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	51	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	56	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	63	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	66	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	62	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	62	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	58	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	58	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	49	\$225,000	\$15,500	\$29,500	\$65,179	\$94,179	\$110,179
6.00%	54	\$225,000	\$20,500	\$29,500	\$65,179	\$94,179	\$115,179
6.00%	48	\$225,000	\$15,500	\$29,500	\$65,179	\$94,179	\$110,179
6.00%	47	\$225,000	\$15,500	\$29,500	\$65,179	\$94,179	\$110,179
4.00%	37	\$225,000	\$15,500	\$29,500	\$0	\$29,000	\$45,000
4.00%	50	\$225,000	\$15,500	\$29,500	\$0	\$29,000	\$45,000
4.00%	45	\$225,000	\$15,500	\$29,500	\$0	\$29,000	\$45,000
4.00%	37	\$225,000	\$15,500	\$29,500	\$0	\$29,000	\$45,000
	57	\$211,000	\$0	\$15,825	\$0	\$15,825	\$15,825
Sub total		\$4,261,000	\$334,000	\$546,825	\$912,500	\$1,450,325	\$1,775,325
Staff Cost		\$2,329,000	\$0	\$174,675	\$0	\$174,675	\$174,675
Totals:		\$6,590,000		\$721,500	\$912,500	\$1,625,000	\$1,950,000
% to 6% Owners:			50.8%		61.1%	100.0%	82.9%

Cost to increase gateway to 7.5% = \$63,500, so 6% owners get \$912,500 for \$63,500 + admin fees.

Sample "Age Graded" Cash Balance Offset Design

Ownership %	Age	Date of Hire	Estimated 2006 Plan Compensation	401(k) with Catch up	Profit-Sharing	DB "Cash Balance" Accrual	DB + Profit-sharing	DB + Profit-Sharing + 401(k)
6.00%	56	11/13/1999	\$220,000	\$20,000	\$29,000	\$63,250	\$92,250	\$112,250
6.00%	51	2/17/1981	\$220,000	\$20,000	\$29,000	\$48,250	\$77,250	\$97,250
6.00%	51	5/15/1996	\$220,000	\$20,000	\$29,000	\$48,250	\$77,250	\$97,250
6.00%	56	2/5/1979	\$220,000	\$20,000	\$29,000	\$63,250	\$92,250	\$112,250
6.00%	63	11/1/1968	\$220,000	\$20,000	\$29,000	\$92,000	\$121,000	\$141,000
6.00%	66	2/12/1973	\$220,000	\$20,000	\$29,000	\$102,250	\$131,250	\$151,250
6.00%	62	8/4/1974	\$220,000	\$20,000	\$29,000	\$87,250	\$116,250	\$136,250
6.00%	62	11/1/1974	\$220,000	\$20,000	\$29,000	\$87,250	\$116,250	\$136,250
6.00%	58	9/14/1992	\$220,000	\$20,000	\$29,000	\$70,500	\$99,500	\$119,500
6.00%	58	1/5/1982	\$220,000	\$20,000	\$29,000	\$70,500	\$99,500	\$119,500
6.00%	49	6/11/1984	\$220,000	\$15,000	\$29,000	\$43,250	\$72,250	\$87,250
6.00%	54	9/5/1980	\$220,000	\$20,000	\$29,000	\$56,750	\$85,750	\$105,750
6.00%	48	5/15/1995	\$220,000	\$15,000	\$29,000	\$41,000	\$70,000	\$85,000
6.00%	47	3/28/1988	\$220,000	\$15,000	\$29,000	\$38,750	\$67,750	\$82,750
4.00%	37	8/29/1994	\$220,000	\$15,000	\$29,000	\$0	\$29,000	\$44,000
4.00%	50	3/5/1990	\$220,000	\$15,000	\$29,000	\$0	\$29,000	\$44,000
4.00%	45	9/14/1992	\$220,000	\$15,000	\$29,000	\$0	\$29,000	\$44,000
4.00%	37	9/14/1998	\$220,000	\$15,000	\$29,000	\$0	\$29,000	\$44,000
Sub Total			\$3,960,000	\$325,000	\$522,000	\$912,500	\$1,434,500	\$1,759,500
Staff Cost	57	4/1/1991	\$2,540,000	\$0	\$190,500	\$0	\$190,500	\$190,500
Totals:			\$6,500,000	\$325,000	\$712,500	\$912,500	\$1,625,000	\$1,950,000
% to 6% Owners:				50.8%		61.1%	100.0%	82.9%

Cost to increase gateway to 7.5% = \$63,500, so 6% owners get \$912,500 for \$63,500 + admin fees.

Eligibility and Minimum Participation Requirements

Both Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code contain standards regarding the minimum age and minimum length of service requirements that an employer may impose on employees before allowing them to participate in the employer's qualified plan. Statutory exclusions are also available. Furthermore, participation requirements unrelated to age and service requirements may also be permitted if not discriminatory. Both the provisions of the plan and the plan in operation must satisfy the minimum participation (and vesting standards).

Minimum Age and Service Requirements

A qualified plan may not require, as a condition of participation in the plan, that an employee complete a period of service extending beyond the later of (1) age 21, or (2) the completion of one year of service or the completion of two years of service if the plan provides that after not more than two years of service each participant has a nonforfeitable right to 100 percent of his or her accrued benefit.⁵⁴ If a plan is maintained

⁵⁴ IRC Section 410(a).

exclusively for employees of an IRC Section 501(a) tax exempt educational institution, the minimum age limitation can be 26 instead of 21, but only if the plan provides that each participant having at least one year of service has a nonforfeitable right to 100 percent of his or her accrued benefit.⁵⁵ A plan generally may not exclude from participation in the plan an employee who is beyond a specified age.⁵⁶ A plan may provide more liberal eligibility requirements—for example, no age or service requirements—in which case participants would become eligible on their date of hire. The minimum age requirement must be satisfied before the commencement of participation rules are applied. Thus, unless a plan provides for retroactive participation or a “nearest to” entry date, a participant will have generally attained the age requirement, if any is specified, on or before the date participation is to commence.

Two Year Service Requirement

Instead of requiring one year of service, a plan that provides 100 percent vesting may require that an employee complete 2 years of service to share in any employer matching or discretionary profit-sharing contributions.⁵⁷ Employers with high turnover following initial employment may find the two year rule more advantageous than a vesting schedule. The two year rule does not apply to elective contributions made by a participant in a 401(k) plan. Thus, the plan may have to provide for a one year of service requirement for elective contributions, while providing for a two year requirement for employer derived contributions. Using overlapping eligibility computation periods may result in an eligibility period of less than two years. Generally, dual eligibility plans will use each employee's employment years as that employee's computation period. However, top heavy contributions (if required) would have to be made for all participants, including those participants only eligible to make elective contributions. Vesting and nonforfeitability is discussed later in this chapter. In addition, if a plan is cross tested and determines the non discrimination of contributions on a benefits basis, the plan must meet the special gateway requirements providing potentially greater contributions.

The term accrued benefit means, in the case of a defined benefit plan, the employee's accrued benefit determined under the plan expressed in the form of an annual benefit commencing at normal retirement age, or, in the case of any other kind of plan, the balance of the employee's account.⁵⁸ The accrued benefit under a cash balance plan is defined to be the theoretical account balance. Generally, the accrued benefit of a participant may not be decreased by an amendment to the plan.

Commencement of Participation

A qualified plan must provide that any employee who has satisfied the minimum age and service requirements (discussed below) and who is otherwise entitled to participate in the plan is to commence participation in the plan no later than the earlier of (1) the first day of the first plan year beginning after the date on which the employee satisfied such requirements, or (2) the date six months after the date on which he satisfied such requirements, unless the employee was separated from service before whichever date is applicable.⁵⁹ Additional requirements, not related to age or service, may be imposed by a qualified plan as a condition of participation, provided it does not have the effect of imposing an additional age or service requirement (even if the provision does not specifically refer to age or service).⁶⁰ Most qualified plans provide for semiannual entry dates following satisfaction of the age and service requirement, some provide for a “nearest to” annual entry date. Other schemes are acceptable, so long as it is not possible for the commencement of participation to be deferred beyond the later of dates indicated above.

⁵⁵ IRC Sections 401(a)(3), 410(a)(1); Temp. Treas. Reg. Section 1.410(a) 3T.

⁵⁶ IRC Section 410(a)(2).

⁵⁷ IRC Section 410(a)(1)(B)(i).

⁵⁸ IRC Section 411(a); Treas. Reg. Section 1.411(a) 7.

⁵⁹ IRC Section 410(a)(4); Treas. Reg. Section 1.410(a) 4(b)(1); Rev. Rul. 80 360 (1980 2 CB 142), see illustrations of entry dates.

⁶⁰ Treas. Reg. Section 1.410(a) 3(d), 1.410(a) 3(e)(1).

Example. A plan provides for a participant to commence participation on the plan's annual entry next following their completion of a year of service and attainment of age 21. The plan is not a qualified plan. For example, a full time employee who turns age 21 during the year (or on an entry) date might have to wait more than six months to commence participation.

Example. Over and Up are divisions of the same company. New employee apprentices are initially hired by Over for four years and then transferred to Up. A plan provision that requires employment in Over is a disguised service requirement.

Example. A qualified plan that excludes part-time employees from plan participation will violate the IRC Section 410 participation rules if it is possible that such an employee could complete the requirement of 1,000 hours and one year of service. (See the following section for a full discussion.)⁶¹

Year of Service

The term year of service means a 12-month period, measured from the date the employee enters service, during which the employee has worked at least 1,000 hours; special rules apply if there are breaks in service and there is absence from work due to pregnancy, childbirth, or adoption of a child.⁶² Special rules also apply in the cases of seasonal industries and maritime industries.⁶³ A provision excluding part-time employees is not permitted in a qualified plan.

The initial eligibility period ends on the date that is one year after the date of employment. To avoid burdensome recordkeeping, a plan may provide that subsequent eligibility computation periods be shifted to the plan year, instead of continuing to be based on employment years. If eligibility periods overlap, however, an employee must be credited with a year of service during each of the overlapping computation periods in which the 1,000 hours of service are completed.

Example. A qualified profit-sharing plan provides an employee to complete one year of service to be eligible to participate in the plan. The term year of service is defined by the plan as the completion of 1,000 hours of service during the 12-month period commencing on an employee's date of hire. The plan provides that if an employee does not satisfy the requirements for eligibility during that period, then the subsequent 12-month period will shift to the plan year that includes the last day of the initial eligibility period. The plan year is defined as the calendar year. The plan provides that an eligible employee (an employee who completes a year of service) commences participation on the January 1, or June 1, semiannual entry date following their satisfaction of the eligibility requirement.

Mary commences employment on July 1, 2007. During the next 12 months (ending on May 31, 2008), Mary completes 800 hours of service. So far, Mary is not eligible to participate. For the 12 month period beginning on January 1, 2008 (the overlapping computation period) she completes 1,000 hours of service. Mary is eligible, her participation will commence on the January 1, 2009, entry date; that is, the next entry date after the end of the 12-month computation period (in which she completed her year of service) provided she is employed on that date and has satisfied the plan's age requirement. Mary is credited with one year of eligibility service.

⁶¹ Rul. Ltr. 9508003 (Nov. 10, 1994) retroactive disqualification of new plan avoided by timely amendment.

⁶² IRC Sections 410(a)(3), 410(a)(5); Treas. Regs. Sections 1.410(a) 5, 1.410(a) 6, 1.410(a) 9; Temp. Treas. Reg. Section 1.410(a) 8T.

⁶³ IRC Sections 410(a)(3)(B), 410(a)(3)(D); Treas. Reg. Section 1.410(a) 5. No guidance has been issued with respect to seasonal employees, but see, DOL Reg. § 2530.200b 6 regarding maritime employees where 125 hours of service is generally required to complete one year of service.

Example. Same facts as in the preceding example, except Mary completes 1,000 hours of service during her initial computation period. Mary's participation will commence on July 1, 2008; the next entry date following her completion of a year of service provided she is employed on that date and satisfied the plan's age requirement. Mary is credit with two years of eligibility service.

If the computation period is less than 12 months, hours must be disregarded and an elapsed time method must be used. An employee that is terminated before his or her participation begins, but after completing the 1,000-hour year of service eligibility requirement, is deemed not to have begun participation in the plan.⁶⁴

Past Service With Former Employer

Past service with former employers may be used for the purpose of determining eligibility to participate in a plan provided (1) the former employers are specified in the plan or trust, (2) all employees having such past service are treated uniformly, and (3) the use of the past service factor does not produce discrimination in favor of the HCEs.⁶⁵ Credit for service may also be credited for services performed as partners or sole proprietors prior to becoming employees in a successor corporation for participation purposes.⁶⁶

Service for Predecessor Employer

If an employer maintains a plan of a predecessor employer, service for such predecessor shall be treated as service for the employer. If an employer maintains a plan which is not the plan maintained by a predecessor employer, service for such predecessor shall, to the extent provided in regulations prescribed by the Secretary of the Treasury, be treated as service for the employer.⁶⁷

Related Employer Service Rules

All employees of all corporations which are members of a controlled group of corporations (within the meaning of IRC Section 1563(a), determined without regard to IRC Sections 1563(a)(4) and (e)(3)(C)) shall be treated as employed by a single employer. With respect to a plan adopted by more than one such corporation, the applicable deduction limitations shall be determined as if all such employers were a single employer, and allocated to each employer in accordance with regulations prescribed by the Secretary of the Treasury. Similar rules apply to partnerships and sole proprietorships.⁶⁸

Hours of Service

Depending upon the method of counting hours and crediting service, an employer can structure a plan to favor one group of employees over another group. In addition, the number and structure of plan participants could also change depending upon which method is used. Careful analysis and/or educated guesswork is often needed to determine the most suitable plan design.

An hour of service is generally each hour for which an employee is paid or entitled to compensation, either with respect to the performance of duties or for reasons, such as vacation, sick leave, holiday, jury duty, military duty, and so on.⁶⁹ Any hour for which the employee receives back pay is an hour of service and must be credited to the computation period to which the back pay pertains.

Hours of service does not have to be credited for compensation maintained under a plan that is solely for the purpose of complying with worker's compensation, unemployment compensation, or disability insurance

⁶⁴ Treas. Reg. Section 1.410(a) 4(b); DOL Reg. Section 2530.200b 1(b).

⁶⁵ Rev. Rul. 72 5 (1972 1 CB 106).

⁶⁶ Let. Rul. 7742003 (no date available).

⁶⁷ IRC Section 414(a)(1) (2).

⁶⁸ IRC Section 414(b).

⁶⁹ IRC Section 410(a)(3)(C); DOL Reg. Section 2530.200b 2.

laws.⁷⁰ Neither do hours have to be credited for any hour for which the employee is reimbursed for medical expenses.⁷¹

Hours also have to be credited when no duties are performed and the employee is entitled to compensation. However, not more than 501 hours are required to be credited to an employee who performs no duties during the year. If no duties are performed, payment generally is based on units of time (hours, days, weeks, or months). The hours to be credited are the regularly scheduled working hours on which the payment is based. For an employee without a regular work schedule, a plan may provide for the number of hours to be calculated based on a 40-hour workweek or an 8-hour day, or on any reasonable basis that is consistently applied and reflect the average hours worked by the employee or by other employees in the same job classification over a representative time period.⁷² If payment is made in a lump sum; that is, not based on units of time, the hours to be credited are computed by dividing the lump sum payment by the employee's most recent hourly rate of compensation prior to the period for which no duties were performed.⁷³

A plan could provide for crediting service using an equivalency method or under an elapsed time method, rather than actual hours.

Equivalency Method

To simplify administration, a plan could provide for crediting service using the equivalency method (rather than the actual hour method) provided it is not discriminatory and consistently applied. For example, the equivalency method could be used for exempt employees, and the actual hours method for nonexempt employees. In some cases, under the equivalency method, nonperformance hours are disregarded. This may be advantageous in some situations. Equivalencies can be based on hours worked, periods of employment, regular time hours, or periods of employment, each of which is discussed in the following sections.

Hours Worked Method

The hours worked method⁷⁴ does not take into account hours for which no duties are performed; such as, vacation, sick leave, holiday, jury duty, military duty, and so on. Because employees might be credited with fewer hours, under this method, a year of service requires the completion of a fewer number of hours, as shown in the following:

Credit For	Hours Required
Year of Service	870
500 hours	435
501 hours	436 (to avoid a one year break in service)

Example. A qualified plan uses the equivalency method based on hours worked. Melissa, a full-time employee, completed 490 hours of service before she was called to be a juror in a criminal trial. Melissa was paid by her employer at her regular rate while she was on jury duty, but did not return until after the end of the initial computation period. She has not completed a year of service during this computation period. Under this method, Melissa is only credited with the 490 hours she worked, but has not incurred a break in service

⁷⁰ DOL Reg. Section 2530.200b 2(a)(2)(ii).

⁷¹ DOL Reg. Section 2530.200b 2(a)(iii).

⁷² DOL Reg. Section 2530.200b 2(b)(1).

⁷³ DOL Reg. Section 2530.200b 2(b)(2).

⁷⁴ DOL Reg. Section 2530.200b 3(d)(1).

because she completed 436 hours under this method. Melissa did not perform any duties as a juror, so those hours for which she was paid are disregarded.

Equivalencies Based on Earnings

Under the equivalencies based on earnings⁷⁵ method, hours of service are determined by converting an employee's compensation into hours of service. An hourly employee's compensation is divided by their hourly rate, as shown in the following:

Credit For	Hours Required
Year of Service	870
500 hours	435
501 hours	436 (to avoid a one year break in service)

Example. A qualified plan uses the equivalency method based on earnings. During the computation period, Joe earns \$10,900 at his \$25 hourly rate. His 436 hours ($\$10,900 / 25$) are sufficient to avoid a one year break in service, but Joe has not completed the 870 hours needed to complete a year of service this computation period.

Similar rules are provided under the regulations for nonhourly employees. An hourly rate is arrived at, and hours are determined based on compensation. For a non-hourly employee, however, fewer hours are required to complete a year of service, as follows:

Credit For	Hours Required
Year of Service	750
500 hours	375
501 hours	376 (to avoid a one year break in service)

Periods of Employment Method

Under the periods of employment⁷⁶ method, the number of hours of service to be credited is based on the following periods in which the employee received at least one hour of service, as shown in the following:

Period Worked During	Hours Credited	Full Time Employee Estimated Hours With No Leave
Day	10	2,600 (10 × 260 days)
Week	45	2,340 (45 × 52 weeks)
Semimonthly period	95	2,280 (95 × pay period)
Month	190	2,280 (190 × 12 months)

⁷⁵ DOL Reg. Section 2530.200b 3(f).

⁷⁶ DOL Reg. Section 2530.200b 3(e).

The weekly equivalency of 45 hours generally credits an employee with the least number of hours.

Example. A qualified plan uses the equivalency method based on periods of employment. 45 hours are credited for each week in which at least one hour of service is credited. Billy works 3 hours on Sunday and continues to do so for 24 weeks during the computation period. He is credited with 1,080 hours, more than the 1,000 hours required to receive credit for a year of service.

Regular Time Hours Method

The hours worked method does not take into account any hours for which the employee did not perform any duties. Under the regular time hours method,⁷⁷ only regular time hours are considered; overtime hours are ignored, as shown in the following:

Hours Required	Credit For
750	Year of Service
375	500 hours
376	501 hours (to avoid a one year break in service)

Example. A qualified plan uses the equivalency method based on regular hours worked. During the relevant computation period George worked 375 regular hours and completed 30 overtime hours. George will only be credited with 375 hours and has incurred a one-year break in service; he worked less than 376 hours, the 501-hour equivalency.

Elapsed Time Method

Under the elapsed time method,⁷⁸ service is based on an employee's period of service beginning on the date employment begins and ends on the earlier of the following dates:

1. The date the employee quits, dies, retires, or is discharged
2. The first anniversary of the first day of a period of absence from service for any other reason, such as vacation, holiday, layoff, or disability

If an employee separates for any reason other than quitting, retiring, or being discharged, and returns to work within 12 months, the severance period is included within the period of service.

Example. A qualified plan uses the equivalency method based on elapsed time. Holly commences employment on January 1 and is laid off five months later on May 31. She is rehired six months later on November 1 and continues in her employment indefinitely. Holly will complete a year of service on December 31.

Caution: Using an equivalency method for some purposes under a plan and the actual hours method for other purposes (although it is permitted for crediting service) may result in discrimination in operation and generally should be avoided.

⁷⁷ DOL Reg. Section 2530.200b 3(d)(2).

⁷⁸ Treas. Reg. Section 1.410(a) 7. Not contained in DOL regulations under ERISA.

Break in Service

In general, all years of service with an employer are taken into account for eligibility purposes. However, years in which an employee incurs a break in service generally can be ignored.

A one-year break in service is a calendar year, plan year, or other 12-month period designated by the plan during which the employee completes fewer than 501 hours of service.⁷⁹ As previously discussed, however, fewer hours are required under some of the elapsed time methods of crediting hours of service for purposes of receiving credit for a year of service and for incurring a break in service (376 or 436 hours); another ignores certain breaks of less than 12 months in duration.

It is often difficult to predict the effect that a break in service will have on eligibility or vesting. Nonetheless, the break in service rules are a factor that may be able to be considered in some well defined industries and businesses that have maintained such history and records. Simply factoring in several weeks or months of consecutive vacation or other leave will not always produce the same effect as when the same amount of leave is spread out over different periods. Special care must be taken in determining service in seasonal and maritime industries, previously discussed.

Minimum Coverage Requirements Tests

A qualified plan is discriminatory unless it satisfies either a ratio percentage test, or an average benefits test.⁸⁰

A qualified plan must benefit either:

1. 70 percent of all NHCEs, according to the percentage test, or
2. A percentage of the NHCEs that is at least 70 percent of the percentage of HCEs benefiting under the plan is the average ratio test.⁸¹

Ratio Percentage Test

A plan's ratio percentage is determined by dividing the percentage of the NHCEs who benefit under the plan by the percentage of the HCEs who benefit under the plan.⁸²

Example. Cobalt Company has a profit-sharing plan that covers 30 of its 100 nonexcludable HCEs and 85 of its 100 nonexcludable NHCEs. The plan's ratio percentage is computed as follows:

The percentage of the HCEs who benefit under the plan can be computed as follows:

$$\frac{85/100}{30/100} = \frac{.85}{.30} = 283\%$$

Cobalt's ratio percentage is greater than 70 percent, it passes the ratio percentage test.

⁷⁹ IRC Section 410(a)(5). A similar rule applies for vesting purposes, see IRC Section 411(a)(6)(A); DOL Reg. Section 2530.200b 4.

⁸⁰ Governmental plans are exempt from the participation requirements. IRC Section 401(a)(5)(G), 410(c)(1)(A); Notice 2003 6 (2003 3 IRB 298).

⁸¹ IRC Section 410(b)(1).

⁸² Treas. Reg. Section 1.410(b) 9.

Example. Same facts as in the preceding example, except 90 nonexcludable HCEs are covered and only 60 nonexcludable NHCEs are covered. Here, the ratio test is not satisfied; .6 divided by .9 equals 66.6 percent, which is less than 70 percent. Perhaps the plan can pass the average benefits test.

Average Benefits Test

A plan that cannot satisfy the ratio percentage test may still pass the coverage requirement by satisfying the average benefits test. There are two elements of the average benefits test and both must be met for a plan to satisfy the average benefits test.⁸³ The two components are:

- The nondiscriminatory classification test, and
- The average benefits percentage test

Nondiscriminatory Classification Test

In order to pass the nondiscriminatory classification test, a plan must benefit “such employees as qualify under a classification set up by the employer and found by the Secretary [of the Treasury] not to be discriminatory in favor of highly compensated employees.”⁸⁴ Regulations require that (1) the classification of employees must be reasonable and reflect a bona fide business classification of employees, and (2) the classification must be nondiscriminatory, based on a facts and circumstances test or a safe harbor percentage test (explained below).⁸⁵

To determine whether a classification is nondiscriminatory, the plan’s ratio percentage (as defined above) is compared to a table (see below) that is set forth in the regulations. This comparison produces one of three results:

1. If the plan’s ratio percentage falls below the unsafe harbor percentage, it is discriminatory.
2. If the plan’s ratio percentage falls between the safe harbor and unsafe harbor amounts, it must satisfy a facts and circumstances test.
3. If the plan’s ratio percentage falls at or above the safe harbor amount, the plan is nondiscriminatory.⁸⁶

The regulations contain a table setting forth a safe harbor percentage and an unsafe harbor percentage for every NHCE concentration level.⁸⁷ The table begins with an NHCE concentration of zero to 60 percent, and for that level provides a safe harbor percentage of 50 percent and an unsafe harbor percentage of 40 percent. In other words, for an employer with 100 employees, of whom 40 are highly compensated and only 60 are nonhighly compensated, the classification would automatically be nondiscriminatory under the safe harbor if its ratio percentage were 50 percent or higher. See Chapters 8, and 9, for more information on defined contribution plan design.

⁸³ IRC Section 410(b)(2); Treas. Reg. Section 1.410(b) 2(b)(3).

⁸⁴ IRC Section 410(b)(2)(A)(i).

⁸⁵ Treas. Reg. Section 1.410(b) 4(b), 1.410(b) 4(c).

⁸⁶ Treas. Reg. Section 1.410(b) 4(c).

⁸⁷ Treas. Reg. Section 1.410(b) 4(c)(4)(iv).

The following table sets forth the safe harbor and unsafe harbor percentages at each NHCE concentration percentage:

NHCE Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
99	20.75	20.00

Under the table,⁸⁸ the safe harbor percentage is reduced by three quarters of a percentage point (but not below 20.75 percent) for each whole percentage point by which the NHCE concentration percentage exceeds 60 percent. Thus, for an employer with a NHCE concentration percentage of 99 percent, the safe harbor percentage would be 20.75 percent.⁸⁹ The unsafe harbor percentage is reduced by three quarters of a percentage point (but not below 20 percent) for every whole percentage point by which the NHCE concentration percentage exceeds 60 percent.⁹⁰

Example. Blade Corporation has 200 nonexcludable employees, of whom 120 are NHCEs and 80 are HCEs. Blade maintains a plan that benefits 60 NHCEs and 72 HCEs. Thus, the plan's ratio percentage is 55.56 percent ($(60/120)/(72/80)$), which is below the percentage necessary to satisfy the nondiscriminatory ratio percentage test. Blade's NHCE concentration percentage is 60 percent ($120/200$); thus, Blade's safe harbor percentage is 50 percent and its unsafe harbor percentage is 40 percent. Because the plan's ratio percentage (55.56 percent) is greater than the safe harbor percentage (50 percent), the plan's classification satisfies the safe harbor.⁹¹

Example. Same facts as in the preceding example, except that the plan only benefits 40 NHCEs. The plan's ratio percentage is 37.03 percent ($(40/120)/(27/80)$). The plan's classification is below the unsafe harbor percentage of 40 percent.⁹²

Average Benefits Percentage Test

The second part of the average benefits test requires that the average benefits percentage for NHCEs be at least 70 percent of the average-benefits percentage for HCEs.⁹³

An employee's benefit percentage is his employer provided contributions (including forfeitures and elective contributions) or benefits under all qualified plans maintained by the employer, expressed as a percentage of his or her compensation.⁹⁴ Employee contributions and benefits attributable to employee contributions are not taken into account in calculating employee benefit percentages.⁹⁵ The regulations permit benefit percentages to be determined on either a contributions or a benefits basis, but the benefit percentages for any testing period must be determined in the same manner for all plans in the testing group.⁹⁶ A plan maintained by an employer that has no employees other than HCEs for any year or that benefits no active HCEs for any year is treated as meeting the minimum coverage requirements.⁹⁷

The average benefits percentage means the average of the benefit percentages calculated separately with regard to each employee in the group.⁹⁸ All of an employer's qualified plans must be considered in determining benefit percentages, even if the plan—standing alone—satisfies the percentage test or the ratio test. Nonetheless, an employer who maintains separate lines of business (see below) may test those businesses separately.

⁸⁸ Treas. Reg. Section 1.410(b) 4(c)(4)(iv).

⁸⁹ Treas. Reg. Section 1.410(b) 4(c)(2), 1.410(b) 4(c)(4)(i).

⁹⁰ Treas. Reg. Section 1.410(b) 4(c)(4)(ii).

⁹¹ Treas. Reg. Section 1.410(b) 4(c)(5), ex 1.

⁹² Treas. Reg. Section 1.410(b) 4(c)(5), ex 2.

⁹³ IRC Section 410(b)(2)(A)(ii); Treas. Reg. Section 1.410(b) 5(a).

⁹⁴ IRC Section 410(b)(2)(C)(i).

⁹⁵ Treas. Reg. Section 1.410(b) 5(d)(2).

⁹⁶ Treas. Reg. Section 1.410(b) 5(d)(5).

⁹⁷ IRC Section 410(b)(6)(F); Treas. Regs. Section 1.410(b) 2(b)(5), 1.410(b) 2(b)(6).

⁹⁸ IRC Section 410(b)(2)(B); Treas. Reg. Section 1.410(b) 5.

The benefit percentage for any plan year is computed on the basis of contributions or benefits for that year or, at the election of the employer, any consecutive plan year period (up to three years) ending with the plan year and specified in the election. An election under this provision cannot be revoked or modified without the consent of the Secretary of the Treasury.⁹⁹

Separate Lines of Business Exception

An employer who operates “separate lines of business” may apply the above tests separately with respect to employees in each line of business, so long as any such plan benefits a class of employees that is determined, on a company wide basis, not to be discriminatory in favor of HCEs.¹⁰⁰ A separate line of business exists if the employer, for bona fide business reasons, maintains separate lines of business or operating units. A separate line of business, however, cannot have less than 50 employees (disregarding any employees excluded from the top paid group when determining which employees are highly compensated). A separate line of business must also either meet a statutory safe harbor (with regard to ratios of HCEs) provided in the Code, meet one of the administrative safe harbors provided in final regulations, or request and receive an individual determination from the IRS that the separate line of business satisfies administrative scrutiny.¹⁰¹

Statutory Exclusions

Employees who can be excluded from consideration by statute in meeting the coverage tests generally include:

1. Employees covered by a collective bargaining agreement (provided that retirement benefits were the subject of good faith bargaining between the employee representatives and the employer)
2. Nonresident aliens who receive no U.S. earned income¹⁰²

Waiver of Participation

Although a plan may permit an otherwise eligible employee to waive his or her right to participate, such a waiver may, under some circumstances, result in discriminatory coverage.¹⁰³

Former Employees

Active and former employees are tested separately for purposes of these rules.¹⁰⁴ A plan satisfies the coverage requirement with respect to former employees only if, under all the relevant facts and circumstances, the group of former employees does not discriminate significantly in favor of HCEs.¹⁰⁵

If a plan applies minimum age and service conditions for eligibility purposes and excludes all employees who do not satisfy those conditions, then all employees who fail to satisfy those requirements are excludable employees with respect to that plan. However, such an employee may be treated as an excluded employee if he or she terminates employment with not more than 500 hours of service.¹⁰⁶

⁹⁹ IRC Section 410(b)(2)(C).

¹⁰⁰ IRC Section 410(b)(5).

¹⁰¹ IRC Section 414(r); Treas. Regs. Sections 1.414(r) 5, 1.414(r) 6.

¹⁰² IRC Section 410(b)(3); Treas. Regs. Sections 1.410(b) 6(d), 1.410(b) 9.

¹⁰³ Rev. Rul. 80 351 (1980 2 CB 152).

¹⁰⁴ Treas. Reg. Section 1.410(b) 2(a).

¹⁰⁵ Treas. Reg. Section 1.410(b) 2(c)(2).

¹⁰⁶ Treas. Reg. Section 1.410(b) 6(f)(1).

Employees Treated as Benefiting

Generally, for purposes of meeting the above tests, an employee benefits under a plan for a year only if the employee accrues a benefit or receives an allocation under the plan for that year. However, in the case of a 401(k) plan, any individual who is eligible to make elective contributions is treated as benefiting under the plan.¹⁰⁷

Mandatory Disaggregation

In some cases, a plan or portions of a plan must be disaggregated for purposes of meeting the minimum coverage rules. The mandatory disaggregation requirement requires that certain single plans must be treated as comprising separate plans, each of which is subject to the minimum coverage requirements. The following generally have to be tested separately for coverage purposes:

1. The portion of a plan that includes a cash or deferred arrangement subject to IRC Section 401(k) (or matching and employee after tax contributions subject to IRC Section 401(m)) and the portion that does not
2. The portion of a plan that benefits otherwise excludable employees and the portion that does not
3. The portion of a plan that benefits employees under a collective bargaining arrangement and the portion that benefits nonunion employees
4. A plan that benefits the employees of a separate line of business and any plan maintained by any other line of business if the employer elects to use the separate line of business rules
5. The portion of a plan that is an ESOP and the portion that is a non-ESOP

For testing the benefits of employees who change from one qualified separate line of business to another, a reasonable treatment must be used.¹⁰⁸

Permissive Aggregation

For purposes of applying the ratio percentage test and the nondiscriminatory classification test, an employer may elect to designate two or more of its plans as a single plan, but only if the plans have the same plan years.¹⁰⁹

Dividing the Population

The population of an employer group can be split in order to accomplish specific objectives. The resultant plans must meet the coverage requirements under Section 410(b) of the Code. For example, the CPA firm has 150 employees and is subject to annual audit requirements. The firm can develop two identical plans, each covering 50 percent of the partners and NHCEs. The plans can be tested for discrimination separately under 401(k) and 401(m) since they both meet the coverage requirements under 410(b). Additionally, they are no longer subject to the audit requirements.

¹⁰⁷ Treasury Regulations Section 1.410(b) 3(a)

¹⁰⁸ Treas. Reg. Section 1.410(b) 7(c)(4)(i)(D).

¹⁰⁹ Treas. Regs. Sections 1.410(b) 7(d)(1), 1.410(b) 7(d)(5).

Example. Client B must limit the contribution to the HCEs since the NHCEs are not saving enough. The Client B has looked at the safe harbor rules and found that the cost of implementing is just too high.

The Safe Harbor rules provide for either:

- A 3 percent of compensation, 100 percent vested employer contribution for all eligible employees or
- A 100 percent matching contribution for the first 3 percent of pay contributed plus 50 percent match for the next 2 percent of pay contributed by the employees; also 100 percent vested.

With high turnover and many employees, either of these can be a costly alternative.

To solve the problem economically, we divide the population and test separate groups. We split the HCEs into two groups, those that want to maximize and those that don't. We also split the NHCEs into two groups, those that contribute and those that don't. The splits are done by general job classifications that are non-discriminatory.

We set up one plan for the savers and one plan for the others. We ensure that each plan meets the required coverage tests under the law and our savers can save more.

This works because we can pass our discrimination tests separately as long as each plan meets the coverage tests.

Client B has the following demographics:

Existing Plan	# of Participants	Average Deferral Percentage
HCEs	75	6.03%
NHCEs	1464	1.83%

The maximum allowed for HCEs is 3.66 percent or 2 times the average for the NHCEs. A significant number of the HCEs will need to take money back and the plan loses its effectiveness.

We parsed the population into two: savers and others. We did this based upon non-discriminatory job classifications and locations. After separating out the statutory exclusions for testing, the results were as follows:

Two Plans

	Savers		Non-Savers	
	# of Participants	Average Deferral Percentage	# of Participants	Average Deferral Percentage
HCEs	14	6.5%	61	2.86%
NHCEs	207	4.5%	1257	1.62%

The discrimination tests are met by each plan separately and the savers can reach their goals.

We could add employer contributions, enhanced matching contributions, safe harbor allocations only to the Savers plan if the demographics work. Adding additional employer benefits, however, would require the use of the average benefits test initially combining both plan populations. This may be difficult to reach.

Defined Benefit 50/40 Test

A defined benefit plan must also satisfy the 50/40 test. A defined benefit plan must benefit the lesser of the following:

1. 50 employees
2. The greater of 40 percent of all employees or two employees (or if there is only one employee, that employee), according to IRC Section 401(a)(26)

A defined benefit plan must meet the participation requirement on each day of the plan year; however, under a simplified testing method, a plan is treated as satisfying this test if it satisfies it on any single day during the plan year so long as that day is reasonably representative of the employer's work force and the plan's coverage. A plan does not have to be tested on the same day each plan year. The regulations also provide that a plan that does not satisfy the test for a plan year may be amended by the fifteenth day of the tenth month after the close of the plan year to satisfy the test retroactively.¹¹⁰

In the micro-plan market, this can be met easily. Assume that Jack and his spouse work together as manufacturing representatives and employ a highly compensated sales person and an assistant. If a defined benefit plan is set up for Jack and his spouse and a defined contribution plan is set up for the sales person and the assistant, then the requirements under Section 401(a) 26 are met. General non-discrimination testing rules will still need to be met, but higher deduction amounts may be achieved.

Cross Tested Plans

When a defined contribution plan is a cross-tested plan for nondiscrimination, benefits are taken into account (rather than contributions). Similarly, a defined benefit plan is cross-tested based on contributions (rather than benefits). These plans are also called age weighted because they generally result in higher contribution rates for older employees. However, age weighing is also available without cross-testing, under a uniform points allocation formula safe harbor for defined contribution plans. The general rules for converting allocations under a defined contribution plan to equivalent benefits and for converting benefits under a defined benefit plan to equivalent allocation rates are explained in the Treasury Regulations.¹¹¹

The most common form of cross-testing is called new comparability. The new comparability feature uses cross-testing to show that contributions under a profit-sharing plan provide nondiscriminatory benefits. Cross-testing can also involve aggregating a defined benefit plan with a defined contribution plan, and testing the plans together on the basis of the benefits they provide. Cross-tested and general tested plan designs are more fully discussed in Chapter 9.

Contributions

At this point, the identity of participants has been determined. How contributions are made and allocated must be considered in the plan's design. Generally, a small business owner's objective in allocating contributions is to provide greater benefits for more HCEs and/or key employees, while reducing the costs associated with contributions for all others. Consideration must also be given to forfeitures (generally contributions or

¹¹⁰ Treas. Reg. Sections 1.401(a)(4) 11(g), 1.401(a)(26) 7(c).

¹¹¹ See Treas. Reg. Sections 1.401(a)(4) 8.

benefits that are forfeited under the plan's vesting schedule) after the occurrence of a break in service. Contributions made under a plan can not be discriminatory in favor of HCEs.

Employees not included in the plan but who are covered by a collective bargaining agreement can be excluded from consideration in meeting the nondiscrimination requirement if there is evidence that retirement benefits were the subject of good faith bargaining between the employee representatives and the employer; however, if the union employees are covered under the plan, benefits or contributions must be provided for them on a nondiscriminatory basis. Nonresident aliens with no U.S. earned income may also be excluded.¹¹²

The exclusive rules for determining whether a plan satisfies the nondiscrimination requirements are contained regulations under IRC Section 401(a)(4).¹¹³ It is not required that both contributions and benefits be nondiscriminatory. A plan may satisfy this requirement on the basis of either contributions or benefits, regardless of whether the plan is a defined benefit plan or a defined contribution plan. The process of testing defined benefit plans on the basis of contributions or defined contribution plans on the basis of benefits is referred to as cross-testing.

A plan will not be considered discriminatory merely because contributions or benefits bear a uniform relationship to the employees' compensation.¹¹⁴ IRC Section 401(a)(4) is satisfied only if the plan complies both in form and in actual operation with its regulations; intent is irrelevant.¹¹⁵ A plan sponsor has two basic options for ascertaining that a plan provides nondiscriminatory contributions or benefits:

- Design the plan to meet one of the safe harbors.
- Pass the general test on an annual basis.

A plan that does not meet the requirements for one of the safe harbors must use the general test. The safe harbor methods are design based; essentially, they require the plan to have uniformity provisions that reduce the risk of discrimination. As a result, annual testing is unnecessary. Practitioners will find that the safe harbors are simpler and less costly to apply than the general test, which requires annual review and focuses on actual plan results (rather than plan design).

Defined Contribution Safe Harbors

The regulations set forth two safe harbor designs for defined contribution plans. Neither of the safe harbors allows the use of permitted disparity. A safe harbor design is either based on the following:

1. *Uniform Allocation Formula.* A defined contribution plan will be nondiscriminatory if it allocates employer contributions and forfeitures for the year under an allocation formula that allocates to each employee (a) the same percentage of plan year compensation, (b) the same dollar amount, or (c) the same dollar amount for each uniform unit of service (not exceeding one week) performed by the employee during the year.¹¹⁶
2. *Uniform Points Allocation Formula.* Such a formula allows a defined contribution plan (other than an ESOP) to be nondiscriminatory even though contributions are weighted for age and/or service, as well as for compensation.¹¹⁷

¹¹² IRC Sections 401(a)(4), 410(b)(3); Ltr. Rul. 8419001 (Dec. 7, 1983).

¹¹³ Treas. Reg. Section 1.401(a)(4) 1(a).

¹¹⁴ IRC Section 401(a)(5)(B).

¹¹⁵ Treas. Reg. Section 1.401(a)(4) 1(a).

¹¹⁶ Treas. Reg. Section 1.401(a)(4) 2(b)(2).

¹¹⁷ Treas. Reg. Section 1.401(a)(4) 2(b)(3).

The use of either of these safe harbors is not precluded by a plan that has nonuniform benefits if the sole reason for the nonuniformity is that the plan provides lower benefits to HCEs than to other employees.¹¹⁸

General Test for Defined Contribution Plans

Defined contribution plans (other than plans subject to IRC Section 401(k) or 401(m)) that do not satisfy one of the safe harbors generally will meet the *nondiscrimination in amount* requirement only if each rate group satisfies the minimum coverage requirements of IRC Section 410(b). For this purpose, a *rate group* exists for each HCE in the plan, and consists of the HCE and all other employees in the plan (whether highly compensated or nonhighly compensated) who have an allocation rate greater than or equal to the HCE's allocation rate. In other words, each employee, regardless of compensation level, is in the rate group for every HCE who has an allocation rate less than or equal to that employee's allocation rate.¹¹⁹

Defined Benefit Safe Harbors

The regulations provide a set of uniformity requirements that apply to all of the defined benefit safe harbors. Generally, the plan must provide a uniform normal retirement benefit in the same form for all employees, using a uniform normal retirement age. For purposes of this requirement, the Social Security retirement age will be treated as a uniform retirement age. The regulations provide for three safe harbors, namely, one for unit credit plans, one for fractional accrual plans (including flat benefit plans), and one for insurance contract plans.¹²⁰

Target Plan Benefits

Because target benefit plans are defined contribution plans that determine allocations based on a defined benefit funding approach, the safe harbor is included in the rules for cross-testing. Target benefit plans are very similar to age weighted profit-sharing plans except their contributions are subject to minimum funding requirements and the benefits under the plan must allow of the joint and survivor conversions and lump sum distributions are subject to spousal consent.

401(k) Plans

Special nondiscrimination tests and design based safe harbors apply in the case of contributions to 401(k) and 401(m) plans.¹²¹

Aggregation and Restructuring

Under certain circumstances, a plan may be aggregated (combined) with other plans or restructured (treated as two or more separate plans) for purposes of meeting the nondiscrimination in amount requirement.¹²² If two or more plans are permissively aggregated and treated as constituting a single plan for purposes of satisfying the minimum coverage requirements, the aggregated plans must also be treated as a single plan for purposes of meeting the nondiscrimination requirements.¹²³ The regulations include guide-

¹¹⁸ Treas. Reg. Section 1.401(a)(4) 2(b)(4)(v).

¹¹⁹ Treas. Reg. Section 1.401(a)(4) 2(c)(1).

¹²⁰ Treas. Reg. Section 1.401(a)(4) 3(b).

¹²¹ IRC Sections 401(k), 401(m); Treas. Reg. Section 1.401(a)(4) 1(b)(2)(ii)(B).

¹²² Treas. Reg. Section 1.401(a)(4) 9(c).

¹²³ Treas. Reg. Section 1.401(a)(4) 9(a).

lines for determining whether several such plans, when considered as a unit, provide contributions and benefits that discriminate in favor of HCEs.

Integrated Plans

An integrated defined benefit plan will not be considered discriminatory merely because the plan is integrated with Social Security (the plan uses the permitted disparity rules). A number of the safe harbor defined benefit plan designs provided in the nondiscrimination regulations allow permitted disparity to be used; however, a defined contribution plan must pass the general test in order to use permitted disparity.¹²⁴

Cross-Testing

The most common form of cross-testing is *new comparability* testing of profit-sharing plans. The new comparability feature uses cross-testing to show that contributions under the plan provide nondiscriminatory benefits. Cross-testing can also involve aggregating a defined benefit plan with a defined contribution plan, and testing the plans together on the basis of the benefits they provide. Final regulations that took effect January 1, 2002, established three testing alternatives under which a cross-tested defined contribution plan can satisfy the nondiscrimination in amount requirement, as well as rules for testing the combination of a defined benefit plan and a defined contribution plan on a benefits basis. The three methods are:

1. *Minimum allocation gateway.* The minimum allocation gateway test sets forth two standards for new comparability plans. First, if the allocation rate for each NHCE in the plan is at least one third of the allocation rate of the HCE with the highest allocation rate under the plan, the gateway will be satisfied. In the alternative, if the allocation rate for each NHCE is at least 5 percent of his or her compensation, the gateway will be satisfied. The gateway is deemed satisfied if each NHCE receives an allocation of at least 5 percent of the NHCE's compensation, based on the plan year compensation.¹²⁵
2. *Broadly available allocation rates.* A new comparability plan need not satisfy the minimum allocation gateway if it provides for *broadly available allocation rates*. To be broadly available, each allocation rate must be currently available to a group of employees that satisfies the IRC Section 410 coverage rules, without regard to the average benefits percentage test.¹²⁶ The final regulations allow groups receiving two different allocation rates to be aggregated for purposes of determining whether allocation rates are "broadly available." For example, a group receiving a 3 percent allocation rate could be aggregated with a group receiving a 10 percent allocation rate if each group passes the coverage test (not counting the average benefits percentage test).¹²⁷
3. *Age based allocation rates.* A plan that provides for age based allocation rates will also be excepted from the minimum allocation gateway if it has a "gradual age or service schedule." A plan has a gradual age or service schedule if the allocation formula for all employees under the plan provides for a single schedule of allocation rates that (a) defines a series of bands based solely on age, years of service or points representing the sum of the two, which applies to all employees whose age, years of service, or points are within each band, and (b) the allocation rates under the schedule increase smoothly at regular intervals (as defined in the regulations). Sample schedules of smoothly increasing allocation schedules, based on the sum of age and service, are included in the final regulations.¹²⁸

¹²⁴ See Chapter 8 for more information.

¹²⁵ Treas. Reg. Section 1.401(a)(4) 8(b)(1)(vi)(A) and (B).

¹²⁶ Treas. Reg. Section 1.401(a)(4) 8(b)(1)(iii)(A).

¹²⁷ Rev. Rul. 2001 30 (2001 1 CB 46); Treas. Reg. § 1.401(a)(4) 8(b)(1)(vii), permitted disparity (integration) may be disregarded.

¹²⁸ Treas. Reg. Section 1.401(a)(4) 8(b)(1)(iv)(A).

Permitted Disparity (Integration)

Permitted disparity is not permitted with respect to (1) ESOPs, (2) elective contributions under a qualified cash or deferred arrangement, or employee or matching contributions as defined in IRC Sections 401(k) and 401(m).¹²⁹

Defined Contribution Plans

Integration under a defined contribution plan is more fully discussed in Chapter 7.

Defined Benefit Plans

A defined benefit plan will not be considered discriminatory merely because the plan provides that a participant's retirement benefit may not exceed the excess of (1) the participant's final pay with the employer, over (2) the retirement benefit, under Social Security law, derived from employer contributions attributable to service by the participant with the employer.¹³⁰

Overall Permitted Disparity

The Code specifies that in the case of an employee covered by two or more plans of an employer, regulations are to provide rules preventing the multiple use of the disparity otherwise permitted. The regulations provide both an annual overall limit and a cumulative overall limit. The annual overall permitted disparity limit requires the determination of a fraction based on the disparity provided to an employee for the plan year under each plan. The annual overall limit is met if the sum of those fractions does not exceed one.¹³¹ The cumulative permitted disparity limit is generally satisfied if the total of an employee's annual disparity fractions under all plans for all years of service does not exceed 35.¹³²

Vesting and Nonforfeitability

At this point, the contributions have been made or benefits have been earned and the employee is entitled under the terms of the plan to a distribution of his or her accrued benefit, but only to the extent that the accrued benefit is vested and nonforfeitable under the plans provision. There is a distinction between a vested benefit and a nonforfeitable benefit. A participant is *vested* if he or she has an immediate, fixed right of present or future enjoyment to his or her accrued benefit. However, a plan with a generous (short) vesting schedule may contain a forfeiture provision that applied, for example, to a participant who quits and goes to work for a competitor of the employer in the area or commits a crime against the employer.¹³³ A right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right.¹³⁴

A qualified plan is not required to provide a preretirement death benefit, aside from the employee's accrued benefit derived from the employee's own contributions. "A right to an accrued benefit derived from employer contributions shall not be treated as forfeitable solely because the plan provides that it is not payable if the participant dies . . ." except in the case of a survivor annuity if the plan provides for early retirement as

¹²⁹ Treas. Reg. Section 1.401(l) 1(a)(4).

¹³⁰ IRC Section 401(a)(5)(D)(i); Treas. Reg. Section 1.401(a)(5) 1(d)(2).

¹³¹ Treas. Reg. Section 1.401(l) 5, 1.401(l) 5(b)(1).

¹³² Treas. Regs. Section 1.401(l) 5(c)(1)(i), 1.401(l) 5(c)(2).

¹³³ Rev. Rul. 85 31 (1985 1 CB 153); *Clark v. Lauren Young Tire Center Profit Sharing Trust*, 816 F.2d 480 (9th Cir. 1987); *Noell v. American Design, Inc.*, 764 F.2d 827 (11th Cir. 1985); See, too, Temp. Treas. Reg. Section 1.411(a) 4T.

¹³⁴ Temp. Treas. Reg. Section 1.411(a) 4T(a).

required by the joint and survivor annuity provisions.¹³⁵ Thus, a plan that does not have an option for an annuity type payout could provide that no employer derived benefit is payable if death occurs before the normal retirement age specified in the plan. This could affect the owner, too.

Example. A corporation plan provides that an employee is fully vested in his or her employer derived accrued benefit after completion of three years of service. The plan also provides that if the employee works for a competitor all of his or her rights in the plan are forfeited. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under IRC Section 411 and, therefore, the plan would not satisfy the requirements of that section. If the plan limited the forfeiture to employees who completed less than five years of service, the plan would not fail to satisfy the requirements of IRC Section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under IRC Section 411(a)(2)(A).¹³⁶

A plan must meet the following minimum standards concerning the nonforfeitability of benefits (vesting):¹³⁷

- An employee's right to a normal retirement benefit must be nonforfeitable upon the attainment of normal retirement age.¹³⁸ *Normal retirement age* means the earlier of (1) normal retirement age under the plan, or (2) the later of age 65 or the fifth anniversary of the date participation commenced.¹³⁹ The *normal retirement benefit* is the employee's accrued benefit without regard to whether it is vested. Thus, a plan cannot qualify if it provides no retirement benefits for employees with less than five years of vesting service before the normal retirement age.¹⁴⁰
- If an employee's allocations (or benefit accruals in the case of a defined benefit plan) cease, or if the rate of an employee's rate of allocation or benefit accrual, as applicable, is reduced because of the attainment of any age, the plan will not satisfy the IRC Section 411 minimum vesting standards.¹⁴¹
- An employee's rights in his or her accrued benefit derived from their own contributions must be nonforfeitable at all times.¹⁴²
- If the present value of an employee's vested accrued benefit exceeds \$5,000, the benefit may not be immediately distributed without the consent of the participant, according to IRC Section 411(a)(11)(A). For purposes of the \$5,000 limit, the vested accrued benefit may be determined without regard to rollover contributions and earnings allocable to them.¹⁴³
- An employee must be granted a nonforfeitable rights to his or her accrued benefits derived from employer contributions in accordance with one of the vesting schedules described in the following subsections:

¹³⁵ IRC Sections 401(a)(11), 411(a)(3)(A), 417(c).

¹³⁶ Temp. Treas. Reg. Section 1.411(a) 4T, ex 1.

¹³⁷ IRC Section 401(a)(7).

¹³⁸ IRC Section 411(a).

¹³⁹ IRC Section 411(a)(8).

¹⁴⁰ Rev. Ruls. 84 69 (1984 1 CB 125), 81 211 (1981 2 CB 98).

¹⁴¹ IRC Section 411(b)(1)(H), 411(b)(2).

¹⁴² IRC Section 411(a)(1); see, Rev. Rul. 76 47 (1976 1 CB 109), 78 202 (1978 1 CB 124) as amplified by Rev. Rul. 89 60 (1989 1 CB 113) regarding mandatory employee contributions.

¹⁴³ IRC Section 411(a)(11)(D).

Five Year Cliff Vesting

An employee who has at least five years of service must generally have a nonforfeitable right to 100 percent of his or her accrued benefit.¹⁴⁴ In the case of matching contributions, a three year cliff vesting requirement (100 percent after three years of service) must be satisfied.¹⁴⁵

Three to Seven Year Vesting

An employee who has completed at least three years of service must have a nonforfeitable right to not less than the following percentages of his or her accrued benefit.¹⁴⁶

Years of Service	Minimum Vesting (Percent)
3	20%
4	40%
5	60%
6	80%
7 or more	100%

Under this method, matching contributions must vest over a two to six year period, as follows:¹⁴⁷

Years of Service	Minimum Vesting (Percent)
2	20%
3	40%
4	60%
5	80%
6 or more	100%

The term *year of service* generally means a 12 month period designated by the plan during which the employee has worked at least 1,000 hours.¹⁴⁸ All years of an employee's service with the employer are taken into account for purposes of computing nonforfeitable percentages, except those years specifically allowed to be excluded.¹⁴⁹ If a plan's vesting schedule is modified by a plan amendment, each participant with at least three years of service must be permitted to elect to have his nonforfeitable percentage computed under the plan without regard to the amendment and without regard to the exceptions set forth in IRC Section 411(a)(4).¹⁵⁰

¹⁴⁴ IRC Section 411(a)(2)(A); Temp. Treas. Reg. Section 1.411(a) 3T(b).

¹⁴⁵ IRC Sections 401(m)(4)(A), 411(a)(12)(A).

¹⁴⁶ IRC Section 411(a)(2)(B); Temp. Treas. Reg. Section 1.411(a) 3T(c).

¹⁴⁷ IRC Section 411(a)(12)(B).

¹⁴⁸ IRC Section 411(a)(5).

¹⁴⁹ Treas. Regs. Sections 1.411(a) 5, 1.411(a) 6.

¹⁵⁰ IRC Section 411(a)(10); see, too, Temp. Treas. Reg. Section 1.411(a) 8T(b), 1.411(a) 8T(b)(3).

In computing the period of service under the plan for purposes of determining the nonforfeitable percentage, all of an employee's years of service with the employer or employers maintaining the plan must be taken into account, except that the following years of service may be disregarded:¹⁵¹

1. Before age 18
2. During a period for which the employee declined to contribute to a plan requiring employee contributions
3. With an employer during any period for which the employer did not maintain the plan or a predecessor plan (as defined under regulations prescribed by the Secretary of the Treasury)
4. Breaks in service
5. Before January 1, 1971, unless the employee has had at least three years of service after December 31, 1970
6. In plan years beginning before September 2, 1973, can generally be disregarded provided such service would have been disregarded under the rules of the plan with regard to breaks in service on such date

Faster Vesting Schedules for Certain Plans

The Pension Protection Act of 2006 modified the vesting rules for defined contribution plans and cash balance plans. In general, the accelerated vesting schedules apply to all plan years beginning after 12/31/2006. The vesting schedules must meet one of the following methods:

Year	3 year Cliff	6 Yr Graded
1	0%	0%
2	0%	20%
3	100%	40%
4	100%	60%
5	100%	80%
6	100%	100%

These vesting schedules would apply only to participants that have at least one hour of service after 12/31/06.

For an ESOP that has a loan for the purposes of acquiring qualifying employer securities and the loan is still outstanding on September 26, 2005, the accelerated vesting schedule does not apply to any plan year beginning before the earlier of the date the loan is fully repaid or the date on which the loan was scheduled to be fully repaid as of September 26, 2005.

For Cash Balance Plans, beginning in 2008, employees with 3 years of service must be 100 percent vested.

¹⁵¹ IRC Section 411(a)(4).

Suspension Upon Reemployment

A plan may provide that payment of benefits to a retired employee is suspended for any period during which he resumes active employment with the employer who maintains the plan.¹⁵²

Pattern of Abuse

If there is a pattern of abuse, which is determined solely on the facts and circumstances in each case, a more rapid rate of vesting may be required.¹⁵³

Full Vesting Required on Plan Termination or Discontinuance of Contributions

The plan must provide that upon its termination or partial termination (or, in the case of a profit-sharing plan, also upon complete discontinuance of contributions, other than a temporary suspension), benefits accrued to the date of termination (or date of discontinuance of contributions, other than a temporary suspension) become nonforfeitable to the extent funded at such date.¹⁵⁴ Unless facts suggest a partial termination, the merger or conversion of a money-purchase pension plan into a profit-sharing plan does not result in a partial termination for this purpose, provided the following apply:

1. Employees who are covered by the money-purchase plan remain covered under the ongoing profit-sharing plan.
2. The assets and liabilities in the money-purchase plan retain their characterization under the profit-sharing plan.
3. The employees vest in the profit-sharing plan under the same vesting schedule that existed under the money-purchase plan.¹⁵⁵

Deductions

One of the primary tax advantages of a qualified retirement plan is that a current deduction is allowed for the company's contributions to a plan that provides future benefits. To be deductible, the contribution must be an ordinary and necessary expense and must be compensation for services actually rendered. Also, the contribution, when considered together with the employee's regular compensation, must be reasonable in amount for the services rendered. What constitutes reasonable compensation depends upon the facts and circumstances of each particular case.¹⁵⁶

A contribution on behalf of a self employed individual satisfies the ordinary and necessary business expense requirement if it does not exceed the individual's earned income for the year determined without regard to the deduction for the contribution.¹⁵⁷

Tax deductible contributions to a qualified retirement plan may be made at any time during the taxable year and even after the end of the taxable year up to the due date (including valid extensions) for the filing of the employer's federal income tax return for the particular year. Timely contributions made after the end of

¹⁵² DOL Reg. Section 2530.203 3; Rev. Rul. 81 140 (1981 1 CB 180); Notice 82 23 (1982 2 CB 752).

¹⁵³ ERISA Conf. Comm. Report, 1974 3 CB 437; Prop. Treas. Reg. Section 1.411(d) 1.

¹⁵⁴ IRC Section 411(d)(3).

¹⁵⁵ Rev. Rul. 2002 42 (2002 2 CB 76).

¹⁵⁶ IRC Sections 162, 404; Treas. Reg. Section 1.404(a) 1(b); IRS Ann 98 1 (1998 1 CB 282).

¹⁵⁷ IRC Section 404(a)(8); Temp. Treas. Reg. Section 1.404(a)(8) 1T; but see *Gale v. United States*, 768 F Supp 1305 (ND II 1991).

the taxable year are deductible for that taxable year if either (1) the employer designates in writing to the plan administrator or trustee that the contribution is for the preceding year, or (2) the employer claims the contribution as a deduction on its tax return for the preceding year. The designation, once made, is irrevocable.¹⁵⁸ A contribution is timely if it is made before the income tax return extended due date even if it is made after the return is filed. An employer must obtain a valid extension to file the return in order to extend the time to make a contribution. An application for an extension of time to file is invalid if the employer fails to comply with all requirements of the regulations.¹⁵⁹

The employer's timely mailing of the contribution is adequate. Thus, a contribution mailed and bearing a postage cancellation date no later than the due date of the employer's tax return, including extensions, is timely even if the trust received it after such due date.¹⁶⁰

The Pension Protection Act of 2006 extended the deduction rules. For defined benefit plans, generally effective for plans in existence without substantive amendments within the last 2 years (including new plans), the deduction limit was raised to contribution amounts of up to 150 percent of the current liability over the value of the plan assets.

For 2006 and 2007, combined plan deduction limits under Section 404(a)7 do not apply if the defined contribution plan contributions do not exceed 6 percent of compensation. So for defined benefit and defined contribution plans, beginning in 2006, a participant can contribute the full 401(k) contribution with catch up, have the employer contribute 6 percent of compensation to a profit-sharing plan and make a full deductible contribution to a defined benefit plan.

Example. A single individual earning far in excess of the \$225,000 compensation limit in 2007 wishes to maximize her pension contributions for the year. If she was age 55 and using the previous chart under the defined benefit section of this chapter, she may be able to contribute the following tax deductible amounts.

401-k with catch-up contributions:	\$20,500
Defined Contribution 6%:	\$13,500
Defined Benefit Minimum Required Contribution (Section 412):	<u>\$175,137</u>
Total:	\$209,137

Coordination With Minimum Funding Rules

Tax deductible plan contributions may be made after the end of the taxable year if payment is made by the due date (including extensions) for filing the employer's federal income tax return for that taxable year. For purposes of the minimum funding standards, contributions made after the end of the plan year may relate back to that year if they are made within eight and one half months after the end of the plan year. Thus, contributions made after the due date of the return may satisfy the minimum funding rules under IRC Section 412, but may not be deductible until later years.

¹⁵⁸ IRC Section 404(a)(6); Rev. Rul. 76 28 (1976 1 CB 106); Ltr. Rul. 199935062 (Mar 10, 1999).

¹⁵⁹ Rev. Rul. 66 144 (1966 1 CB 91); IRC Section 6081(b); Treas. Reg. Section 1.6081 3.

¹⁶⁰ Ltr. Rul. 8536085 (Jun. 14, 1985).

Carryforward

Although nondeductible contributions (other than amounts needed to satisfy minimum funding standards) may be subject to a 10 percent excise tax until corrected, such amounts may normally be carried forward.¹⁶¹

¹⁶¹ IRC Section 404(a)(3)(A)(ii).

Chapter 7

Permitted Disparity—Integration of Contributions

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It is possible to have a Safe Harbor Qualified Retirement Plan and still have some disparity when allocating the contribution to the plan. This is referred to as Permitted Disparity. Using the Permitted Disparity rules can reduce an employer's retirement plan contribution expense or provide greater benefits for employees who have compensation in excess to the Taxable Wage Base. Permitted disparity permits an employer that establishes a retirement plan to coordinate payments it makes into the Social Security retirement system for plan purposes. In theory, the Permitted Disparity rule allows a plan to be integrated. The use of Integration avoids a duplication of benefits by allowing that contributions not be made twice on the same compensation. Integrations of a plan allows the Employer to reflect the fact that it contributes on behalf of each employee to the Social Security System the same amount as is contributed by the employee. Thus, an integrated plan's contributions will favor higher paid employees: employees who earn above a certain amount will receive a percentage of the contributions that is higher than their pro rata share of the compensation paid to all participants. A defined benefit plan may also allow for permitted disparity. This chapter discusses the types of plans that may allow for permitted disparity (integration) and how it affects plan design. Spreadsheet or software programs are generally used to design integrated plans, especially when self employed individuals are participants.¹

When a nonsafe harbor qualified retirement plan is tested under 401(a)(4) for discrimination, normally, permitted disparity may be taken into account when performing the test. However, a discussion of the use of permitted disparity when performing discrimination testing is beyond the scope of this chapter.

¹ See, for example, QP SEP Illustrator Software at <http://www.benefitslink.com/gsl>.

Plan Types

Both defined contribution plans and defined benefit plans can provide for permitted disparity.²

Defined Contribution Plans

An integrated defined contribution plan provides the rate at which employer contributions (and normally forfeitures) are allocated to the accounts of participants with respect to compensation above a level specified in the plan, expressed as a percentage of such compensation is greater than the rate at which the contributions are allocated with respect to compensation at or below such specified level, (expressed as a percentage of such compensation).³

Simplified Employee Pension Plans

A simplified employee pension plan (SEP) is a defined contribution plan and may allow for permitted disparity.⁴ Under a special rule only applicable to a SEP, the exclusion of contributions from a participant's income is subject to the \$45,000 (for 2007, plus catch up contribution) limit under Internal Revenue Code (IRC or the Code) Section 415. However, if a SEP provides for permitted disparity the \$45,000 limit is reduced for certain individuals. (See the detailed discussion in the section entitled "Defined Contribution Plan Integration," to follow).

Defined Benefit Excess Plans

An integrated defined benefit excess plan provides the rate at which employer-provided benefits are determined with respect to average annual compensation above a level specified in the plan expressed as a percentage of such compensation is greater than the rate with respect to compensation at or below such specified level expressed as a percentage of such compensation.⁵

Defined Benefit Offset Plans

A defined benefit offset plan provides that each participant's employer provided benefit is reduced by a specified percentage of the participant's final average compensation up to the offset level under the plan.⁶ A defined benefit offset plan may also provide that the benefit in the plan be offset by a percent of the participant's Primary Social Security Benefit, which would be paid to the participant.

Target Benefit Plans

Target benefit plans, which are becoming more uncommon, are generally treated like defined benefit plans for purposes of the permitted disparity rules.⁷

² IRC Sections 401(a)(5)(C) and (D), 401(l); Treas. Reg. Section 1.401(l) 1.

³ Treas. Reg. Section 1.401(l) 1(c)(16)(ii).

⁴ IRC Section 408(k)(3)(D), 414(j).

⁵ Treas. Reg. Section 1.401(l) 1(c)(16)(i).

⁶ Treas. Reg. Section 1.401(l) 1(c)(16)(i).

⁷ Treas. Reg. Section 1.401(l) 1(c)(16)(i).

Defined Contribution Plan Integration

Definitions Relating to Permitted Disparity

- *Base contribution percentage.* The base contribution percentage (BCP) is the percentage of compensation at which the contribution is allocated to the accounts of participants with respect to the compensation of participants at or below the integration level specified in the defined contribution plan for the plan year.⁸
- *Excess contribution percentage.* The excess contribution percentage (ECP) is the percentage of compensation at which the contribution is allocated to the accounts of participants with respect to the compensation of participants above the integration level specified in the defined contribution plan for the plan year.⁹
- *Integration level.* The integration level is the amount of compensation specified in the defined contribution or defined benefit excess plan at or below which the rate of contributions or benefits provided under the plan is less than the rate with respect to compensation above such level.¹⁰ The integration level may not exceed the taxable wage base (TWB) amount in effect on the first day of the plan year.
- *Spread (or disparity rate).* The spread, or disparity rate, is the difference between the excess and base contribution percentages.
- *Taxable wage base.* The TWB is the maximum amount of earnings in any calendar year that may be considered wages for Social Security purposes. For 2007, this amount is \$97,500.
- *Compensation.* Compensation means compensation as defined under the plan provided that such definition is nondiscriminatory and satisfies IRC Section 414(s). An employer may elect not to include as compensation elective deferrals to fringe benefit plans (such as salary deferrals to a 401(k) plan).¹¹

Maximum Spread or Disparity Rate

The excess contribution percentage (the rate of contributions made to the plan by the employer with respect to compensation above the integration level, expressed as a percentage of such compensation) may not exceed the base contribution percentage (the rate of contributions made to the plan by the employer with respect to compensation at or below the integration level, expressed as a percentage of such compensation) by more than the lesser of the following:

1. The base contribution percentage, or
2. The greater of:
 - a. 5.7 percent, or
 - b. The percentage equal to the rate of tax attributable to the old age insurance portion of the Old Age, Survivors, and Disability Insurance (OASDI) as of the beginning of the plan year.¹²

⁸ IRC Section 401(l)(2)(B)(ii); Treas. Reg. Section 1.401(l) 1(c)(4).

⁹ IRC Section 401(l)(2)(B)(i); Treas. Reg. Section 1.401(l) 1(c)(15).

¹⁰ IRC Section 401(l)(5)(A)(i); Treas. Reg. Section 1.401(l) 1(c)(20).

¹¹ IRC Sections 401(l)(5)(B), 414(s).

¹² IRC Sections 401(l)(2)(A), 3111(a) (for 1990 or thereafter, the rate is 6.2%); Notice 89 70 (1989 1 CB 730).

Note. Social Security's OASDI program limits the amount of earnings subject to taxation for a given year. The same annual limit also applies when those earnings are used in a benefit computation. A chart of the OASDI rates for all years is available at <http://www.ssa.gov/OACT/COLA/CBB.html>.

The 5.7 percent factor must be reduced under certain circumstances.

In light of the foregoing, the following, for example, would be true:

- A contribution formula of 10 percent below and 20 percent above a specified dollar level would violate the "lesser of" rules.
- A contribution formula of 2 percent below and 4 percent above a specified dollar level would be permitted, but the plan might be Top-Heavy.
- A contribution formula of 3 percent below and 6 percent above a specified dollar level would be permitted.
- A contribution formula of 6 percent below and 12 percent above a specified dollar level would violate the 5.7 percent rule.

Reduction of Maximum 5.7 Percent Spread (or Disparity Rate)

The maximum spread, or disparity rate, of 5.7 percent depends on the integration level selected for the plan year. A rate of 5.7 percent may be used when the plan is integrated at the TWB or the integration level is set at 20 percent or less of the TWB. If, however, the integration level is set above 20 percent of the TWB¹³ and below the TWB, the maximum spread factor of 5.7 percent must be reduced in accordance with the following rules:

Based on the 2007 TWB of \$97,500, the maximum 5.7 percent spread would be reduced as follows:

If the Integration Level Is More Than	But Not More Than	The 5.7 Percent Maximum Disparity Rate Is Reduced to:
The greater of \$10,000 or 20% of the TWB	80% of the TWB	4.3%
80% of the TWB	An amount less than 100% of the TWB	5.4%

If the Integration Level Is More Than	But Not More Than	The 5.7 Percent Maximum Disparity Rate:
\$0	\$19,500	Remains at 5.7%
\$19,500	\$78,000	Is reduced to 4.3%
\$78,000	\$97,449	Is reduced to 5.4%
N/A	\$97,500	Remains at 5.7%

¹³ Or \$10,000, if 20 percent of the TWB is less than \$10,000. See Treas. Reg. Section 1.401(l) 2(d)(4).

Defined Contribution Plan Uniform Disparity Rule

The EPC must exceed the base contribution percentage by an amount that is uniform for all participants.¹⁴ There is, however, an exception for special employees (other than self-employed individuals) who are not subject to Federal Insurance Contributions Act (FICA) taxes, i.e., employees for whom the employer makes no Social Security contributions. For each employee under an integrated SEP for whom no tax under IRC Sections 3111(a), 3221, or 1401 is required to be paid, employer contributions must be allocated to the account of the employee with respect to the employee's total plan year compensation at the excess contribution percentage rate. That is, if the employer does not pay employment, railroad retirement, or self-employment taxes on behalf of an eligible employee, contributions must be allocated to the account of the employee at the excess contribution percentage rate.¹⁵

Example. An integrated plan formula provides for a contribution of 2 percent of compensation up to \$10,000 and 4 percent of compensation in excess of \$10,000. The plan is not top-heavy. For all employees, the contribution rate for compensation above the integration level is 4 percent and the contribution rate for compensation at or below the integration level is 2 percent. The EPC therefore exceeds the base contribution percentage by an amount that is uniform for all participants.

Example. Fern owns and operates a successful business, Fernway, Inc., and employs her 17-year-old son Tommy on a full-time basis. Tommy earns \$30,000. Because Tommy is under the age of 18 and is in the employ of his parent, his income is not subject to employment taxes.¹⁶ Fernway maintains an integrated profit-sharing plan, and this year it will contribute 5.7 percent of compensation up to \$17,400 and 11.4 percent of compensation that is in excess of \$17,000. The contribution for Tommy will not be integrated. He will receive \$3,420 ($\$30,000 \times .114$) because Fernway is not subject to employment taxes on Tommy's wages.

Practice Pointer: In general, the maximum period for which contributions may be integrated with Social Security contributions is 35 integration years (cumulative permitted disparity years) per employee. Presumably, contributions must also be allocated to the account of a non FICA employee at the EPC in the unlikely event that the employee's cumulative permitted disparity years exceed 35.¹⁷

Top-Heavy Contributions and the Uniformity Rule

A contribution that is made under the top-heavy rules is required to be made to non-key employees. Because the contribution is required under the top-heavy rules, the introduction of a third percentage does not violate the uniformity rule for an integrated plan. Introduction of a third percentage, relative to the integration level, can occur if the base contribution percentage is less than 3 percent and the plan is top-heavy. In such a case,

¹⁴ Treas. Reg. Section 1.401(l) 2(c).

¹⁵ Treas. Reg. Section 1.401(l) 2(c)(2)(iii).

¹⁶ IRC Section 3121(b)(3)(A).

¹⁷ See IRC Sections 408(k)(3)(D), 1402(c), 1402(e), 3121(b); Treas. Reg. Section 1.401(l) 5(a)(3) 1.401(l) 5(a)(5), 1.401(l) 5(c)(1)(i), and 1.401(l) 5(c)(1)(ii). Integration years, or cumulative permitted disparity years, generally are the number of years credited to a participant for allocation or accrual purposes under an integrated SEP or any integrated qualified plan described in IRC Section 401(a) (whether or not terminated) ever maintained by the employer. For purposes of determining a participant's cumulative permitted disparity limit, all years ending in the same calendar year are treated as the same year. If the participant has not benefited under a defined benefit or target benefit plan for any year beginning on or after January 1, 1994, the participant has no cumulative disparity limit, and the rules are deemed satisfied.

the minimum required top-heavy contribution may be made to some but not necessarily all employees with compensation at or below the plan's integration level.

Allocating Integrated Contributions

Using the basic rules set forth above, contributions are made to employees in accordance with the formula contained in the plan. Alternatively, when the amount to be contributed is known, the contribution can be allocated in four steps. Note, the four step method will result in the same allocation to employees as the percentage method (previously discussed), provided the BCP is at least 3 percent. Unless the employer also maintains a defined benefit plan, this method will also satisfy all top-heavy rules.

- *Step 1.* Contributions will be allocated to each participant's account in the ratio that each participant's total compensation bears to *all* participant's total compensation, *but not* in excess of 3 percent of each participant's compensation.
- *Step 2.* Any contributions remaining after the allocation in Step 1 will be allocated to each participant's account in the ratio that each participant's compensation for the plan year in *excess* of the integration level bears to the *excess* compensation of all participants, *but not* in excess of 3 percent.
- *Step 3.* Any contributions remaining after the allocation in Step 2 will be allocated to each participant's account in the ratio that the *sum* of each participant's *total* compensation plus compensation in *excess* of the integration level bears to the sum of all participants' total compensation and compensation in excess of the integration level, *but not* in excess of the maximum disparity rate shown below:

For 2004 if the Integration Level Is More Than	But Not More Than	Then the Maximum 2004 Disparity Limit Is Reduced to:
\$0	\$19,500	Remains at 2.7%
\$19,500 (20% of TWB)	\$78,000	1.3%
\$78,001 (80% of TWB + \$1)	\$97,499	2.4%
TWB	\$97,500	Remains at 2.7%

- *Step 4.* Any remaining employer contributions will be allocated to each participant's account in the ratio that each participant's total compensation for the plan year bears to all participants' total compensation for that year.

Under the four step method, a formula contribution of 2 percent of compensation up to the plan's integration level, plus 4 percent of compensation in excess of the integration level, would not be possible or permitted if the plan were Top-Heavy.

Example. Assume a profit sharing or money purchase pension plan is integrated at \$10,000; assume further that the contribution amount is \$10,025.

Wages	Step 1	Step 2	Step 3	Step 4	Totals (Steps 1 to 4)
\$10,000	\$300	\$0	\$10,000 ÷ \$120,000* × \$6,425 = \$270 (2.7% max. applied)	\$10,000 ÷ \$70,000 × \$3,185 = \$455	\$1,025
\$60,000	\$1,800	\$1,500 (excess comp. of \$50,000 × 3%)	\$60,000 + \$50,000 = \$110,000 ÷ \$120,000 × \$6,425 = \$2,970 (2.7% max. applied)	\$60,000 ÷ \$70,000 × \$3,185 = \$2,730	\$9,000
To be allocated is	Remaining contribution is	Remaining contribution is	Remaining contribution is	Remaining contribution is	Total allocated is
\$10,025	\$7,925	\$6,425	\$3,185	\$0	\$10,025

* \$120,000 = total compensation of \$10,000 + \$60,000, plus excess compensation of \$50,000.

Selecting an Integration Level

Normally the TWB is used for the integration level. However, there could be a need to select a different integration level. Use careful analysis and educated guesswork in selecting the appropriate integration level and spread. Consider the following general rules of thumb:

- Set the integration level at the amount of compensation paid to the highest paid employee that the employer does not wish to favor, but not more than the TWB in effect at the beginning of the plan year.
- For 2007, always try \$97,500 (the TWB), \$78,001 (80 percent of the TWB + \$1), \$19,500 (20 percent of the TWB).
- Owners with slightly higher compensation than employees should consider using a 5.7 percent spread at the \$19,500 (or less) level.
- Nonowners will not always fall into convenient bands. At any given contribution amount, aggregate contributions and the effectiveness percentage for the group of employees being favored will fluctuate as the combination of integration level and spread are applied. Try several approaches.

Example. The Darn Knot Shop, Inc. maintains an integrated profit sharing plan. Lorenzo Darn wants to receive the maximum permitted contribution amount for 2007 of \$45,000 at the lowest overall cost to the employer. For comparative purposes, the plan is illustrated at several different integration levels. The compen-

sation and contribution amounts are shown below. The plan with the least cost would be designed with an integration level of \$78,001 (80 percent of the TWB, plus \$1).¹⁸

		Integration Level and Spread					
		\$0	10,000	\$19,500	\$78,000	\$78,001	\$97,500
		Not Integrated	5.7% Spread	5.7% Spread	4.3% Spread	5.4% Spread	5.7% Spread
Participant	Compensation	Allocated Contribution					
L. Darn	\$165,000	\$ 45,000.00	\$ 45,000.00	\$ 45,000.00	\$ 45,000.00	\$ 45,000.00	\$ 45,000.00
A. Darn	100,000	27,272.73	27,048.18	26,834.86	25,951.45	25,613.43	25,083.41
B. Darn	50,000	13,636.36	13,239.09	12,861.68	12,502.73	12,212.74	12,470.45
D. Harp	50,000	13,636.36	13,239.09	12,861.68	12,502.73	12,212.74	12,470.45
C. Knott	40,000	10,909.09	10,477.27	10,067.05	10,002.18	9,770.19	9,976.36
J. Frank	30,000	8,181.82	7,715.45	7,272.41	7,501.64	7,327.65	7,482.27
Total Cost:		\$118,636.36	\$116,719.08	\$114,897.68	\$113,460.73	\$112,136.75	\$112,482.94

Reduction of \$45,000 Limit in an Integrated SEP

Under a SEP, the amount of total contributions that can be excluded from a participant's gross income is subject to a 25 percent of includible compensation or \$45,000 (for 2007) limit. The \$45,000 amount is reduced, however, in the case of a highly compensated employee (HCE) participating on an integrated plan. The reduction amount is equal to the SEP plan's spread percentage (generally 5.7 percent, 5.4 percent, or 4.3 percent) multiplied by the HCE's compensation not in excess of the plan's integration level or the TWB, whichever is less.¹⁹ Compensation in excess of \$225,000 (the 2007 limit) is not considered.

For 2007, the maximum offset produces a limit of \$39,442.5, which is \$45,000 less the product of the maximum integration level of \$97,500 times the maximum spread. See following chart for examples of typical maximum limits for 2007.

Plan Integration Level	Percent of TWB	Max Spread	Adjusted \$45,000 Limit
\$97,500	100%	5.7%	\$39,442.5
\$78,001	80% + \$1	5.4	\$40,787.95
\$30,000	30.3077%	4.3	\$43,710
\$19,500	20%	5.7	\$43,888.50
\$10,000	.1026%	5.7	\$44,430

Note. Only an NHCE can receive an allocation of \$45,000 in an integrated SEP.

¹⁸ All computations performed using QP SEP Illustrator Software. See <http://www.benefitslink.com/gsl> for more information.

¹⁹ IRC Section 402(h)(2)(B).

The reduction (offset) does not apply to qualified plans. A qualified defined contribution plan may generally provide an HCE with an integrated contribution allocation of up to \$45,000 (assuming the HCE has compensation in excess of \$45,000). It should also be noted that catch up contributions under a SARSEP are not affected by the \$45,000 or \$45,000 (reduced in the case of a SARSEP) limit and may be made in addition to the maximum allocation amounts described above.

Multiple Integrated Plans

An employer may have more than one integrated plan, although the rules can be somewhat unwieldy. It should be noted, however, that the extent of integration may not exceed 100 percent for any year. For example, an employer contributing 6 percent of total compensation may not also provide for a 5.7 percent contribution on compensation in excess of the TWB in two separate plans; however, a contribution of 2.85 percent on compensation in excess of the TWB in two separate plans would be permitted.

Defined Benefit Plan Integration

Defined Benefit Excess Plans

A defined benefit excess plan will meet the permitted disparity rules if the excess benefit percentage (EBP) does not exceed the base benefit percentage (BBP) by more than the maximum excess allowance. For purposes of the permitted disparity rules, target benefit plans are generally treated like a defined benefit plan.²⁰ Benefits must be based on average annual compensation.

Furthermore, any optional form of benefit, preretirement benefit, actuarial factor, or other benefit or feature provided with respect to compensation above the integration level must also be provided with respect to compensation below the integration level. Thus, for example, if a lump sum distribution option, calculated using particular actuarial assumptions, is available for benefits relating to compensation above the integration level, the same lump sum option must be available on an equivalent basis for benefits based on compensation up to the integration level.²¹

Definitions Relating to Permitted Disparity

- *Excess benefit percentage.* The percentage of compensation at which employer provided benefits are determined with respect to average annual compensation of participants above the integration level specified in the defined benefit plan for the plan year²²
- *Base benefit percentage (BBP).* The percentage of compensation at which employer provided benefits are determined with respect to average annual compensation of participants at or below the integration level specified in the defined benefit plan for the plan year.²³
- *Maximum excess allowance.* The maximum excess allowance (MEA) for a plan year is the lesser of either the BBP or .75 percentage points.²⁴

²⁰ Treas. Reg. Section 1.401(l) 2(a)(1).

²¹ IRC Section 401(l)(3); Treas. Reg. Section 1.401(l) 3.

²² IRC Section 401(l)(3)(A); Treas. Reg. Section 1.401(l) 1(c)(14).

²³ IRC Section 401(l)(3)(A); Treas. Reg. Section 1.401(l) 1(c)(3).

²⁴ IRC Section 401(l)(4)(A); Treas. Reg. Section 1.401(l) 3(b)(2).

- *Compensation.* Compensation means compensation as defined under the plan provided that such definition is nondiscriminatory and satisfies IRC Section 414(s). An employer may elect not to include as compensation elective deferrals to fringe benefit plans (such as salary deferrals to a 401(k) plan).²⁵
- *Final average compensation.* Final average compensation means the average of the participant's annual compensation for (1) a period of at least three consecutive years ending with or within the plan year or (2) if shorter, the participant's full period of service; but it does not include compensation for any year in excess of the TWB in effect at the beginning of such year.²⁶
- *Covered compensation.* Covered compensation means the average (without indexing) of the TWBs for the 35 calendar years ending with the year an individual attains Social Security retirement age (SSRA). A defined benefit plan can provide for permitted disparity on the basis of each individual employee's covered compensation. Covered compensation does not refer to the amount of compensation that the employee actually earned, but reflects the ceiling for TWBs over the years. Covered compensation tables are provided at the end of this chapter.
- *Social Security retirement age (SSRA).* SSRA means the age used as the retirement age under the Social Security Act and depends on the calendar year of birth, as follows:²⁷

Year of Birth	SSRA
Before 1938	65
After 1937 but before 1955	66
After 1954	67

Although the SSRA is no longer used for purposes of calculating adjustments to the dollar limitation on benefits payable under a defined benefit plan for limitation years ending after 2001,²⁸ it is still relevant for purposes of calculating certain adjustments with respect to formulas in defined benefit plans using permitted disparity. (See the subsequent section entitled "Defined Benefit Plan Uniform Disparity Rule.")

Example. Fern Corporation maintains a defined benefit excess plan. The formula is .7 percent of the participant's average annual compensation up to covered compensation for the plan year plus 1.5 percent of the participant's average annual compensation for the plan year in excess of the participant's covered compensation for the plan year, multiplied by the participant's years of credited service with the Fern up to a maximum of 35 years. The plan formula provides a benefit that exceeds the MEA because the EBP, 1.5 percent, for the plan year exceeds the BBP, .7 percent, for the plan year by more than the BBP ($1.5\% - 0.7\% = 0.8\%$ which is more than the BBB of .7%).²⁹

Example. The same fact as in the previous example, except the BBP is .75 percent. Fern's plan would meet the permitted disparity rules because the EBP (1.5 percent) would not exceed the BBP (.75 percent) by more than the MEA (.75 percentage point).

²⁵ IRC Sections 401(l)(5)(B), 414(s).

²⁶ 26 IRC Section 401(l)(5)(D); Treas. Reg. Section 1.401(l) 1(c)(17).

²⁷ Social Security Act Section 216(1); IRC Section 415(b)(8).

²⁸ IRC Sections 415(b)(2)(C) (as amended by EGTRRA 2001 Section 611(a)(2)), 415(b)(2)(D) (as amended by EGTRRA 2001 Section 611(a)(3)); EGTRRA 2001 Section 611(i)(2)].

²⁹ Treas. Reg. Section 1.401(l) 3(b)(5).

Example. Heather Corporation maintains a defined benefit excess plan. The formula is 1 percent of average annual compensation up to the integration level for each year of service plus 2 percent of average annual compensation in excess of integration level for each of the first ten years of service plus 1.75 percent of average annual compensation in excess of the integration level for each year of service more than ten. The disparity provided under the plan exceeds the MEA because the EBP for each of the first ten years of service (2 percent) exceeds the BBP (1 percent) by more than .75 percent.

Adjustment to the .75 Percentage Point Factor

If benefits commence prior to or after the SSRA, the .75 percentage point factor discussed above is reduced or increased depending on the age at which benefits commence and the participant's SSRA.

The factors in the following table are applicable to benefits that commence in the month the employee attains the specified age. Accordingly, if benefits commence in a month other than the month in which the employee attains the specified age, appropriate adjustments in the .75 percentage point factor in the MEA (discussed previously) must be made. For this purpose, adjustments may be based on straight line interpolation from the factors in the tables or in accordance with other methods of adjustment specified in the regulations.

Age at Which Benefits Commence	SSRA 67	SSRA 66	SSRA 65
70	1.002	1.101	1.209
69	0.908	0.998	1.096
68	0.825	0.907	0.996
67	0.750	0.824	0.905
66	0.700	0.750	0.824
65	0.650	0.700	0.750
64	0.600	0.650	0.700
63	0.550	0.600	0.650
62	0.500	0.550	0.600
61	0.475	0.500	0.550
60	0.450	0.475	0.500
59	0.425	0.450	0.475
58	0.400	0.425	0.450
57	0.375	0.400	0.425
56	0.344	0.375	0.400
55	0.316	0.344	0.375

Example. The Clock Corporation maintains a defined benefit excess plan. The plan provides that for an employee with an SSRA of 65, the normal retirement benefit is 1 percent of average annual compensation up

to the integration level, plus 1.25 percent of average annual compensation in excess of the integration level, for each year of service up to 35. For an employee with at least 20 years of service, the plan provides a benefit commencing at age 55 that is equal to the benefit payable at age 65. For that employee, the disparity provided under the plan at age 55 is .25 percent (1.25% – 1.00%). Because this disparity does not exceed the .344 percent factor provided in the table for a benefit payable at age 55 to an employee with an SSRA of 66, Clock's plan satisfies the requirements with respect to the early retirement benefit. The plan does not use the simplified table.

Since participants will generally have different SSRAs, the following simplified table may be used.³⁰

Age at Which Benefits Commence	Simplified Table
70	1.048
69	0.950
68	0.863
67	0.784
66	0.714
65	0.650
64	0.607
63	0.563
62	0.520
61	0.477
60	0.433
59	0.412
58	0.390
57	0.368
56	0.347
55	0.325

Excess Benefit Plan Integration Levels Requirements

For defined benefit excess plans, the integration level must meet one of the following requirements:³¹

- The integration level for all participants is a single dollar amount that does not exceed the greater of \$10,000 or one half of the covered compensation of an individual who attains SSRA in the calendar year in which the plan year begins.

³⁰ Treas. Reg. Section 1.401(l) 3(e).

³¹ Treas. Reg. Section 1.401(l) 3(d).

- The integration level for all participants is a single dollar amount that is greater than the amount determined above, that does not exceed the TWB, and that satisfies special demographic requirements, and the .75 percent factor is adjusted.
- The integration level for each participant is the participant's covered compensation.
- The integration level for each participant is a uniform percentage (greater than 100 percent) of each participant's covered compensation that does not exceed the TWB in effect for the plan year, and the .75 percent factor is adjusted.
- The integration level for all participants is a single dollar amount (described above), and the .75 percent factor in the MEA is reduced to the lesser of an adjusted factor or 80 percent of the otherwise applicable factor.

Defined Benefit Offset Plans

A defined benefit offset plan will meet the permitted disparity rules if the participant's accrued benefit is not reduced by reason of the offset by more than the maximum offset allowance (MOA) and benefits are based on average annual compensation.³²

A defined benefit plan may offset a participant's benefit by a percentage of the participant's primary insurance amount under Social Security.³³

Maximum Offset Allowance

The maximum offset allowance (MOA) for a plan year is the lesser of the following:

1. .75 percentage point
2. One half of the gross benefit percentage multiplied by a fraction (not to exceed item 1), the numerator of which is the participant's average annual compensation and the denominator of which is the participant's final average compensation up to the offset level. (The gross benefit percentage is the percentage of employer provided benefits, before application of the offset, with respect to a participant's average annual compensation.³⁴)

Example. Doll Corporation maintains a defined benefit offset plan. The formula provides that, for each year of credited service with the company up to a maximum of 35 years, a participant receives a normal retirement benefit equal to 2 percent of the participant's average annual compensation, reduced by .75 percent of the participant's final average compensation up to covered compensation. The plan meets the permitted disparity rules because the MOA is equal to .75 percent, the lesser of .75 percent or one half of the gross benefit percentage of 1 percent ($\frac{1}{2} \times 2$ percent).

Example. Same facts as in the preceding example, except that the normal retirement benefit equal to 1 percent of the participant's average annual compensation, the plan would not meet the permitted disparity rules because the MOA would be equal to .5 percent, the lesser of .75 percent or one half of the gross benefit percentage of $\frac{1}{2}$ percent ($\frac{1}{2} \times 1$ percent).³⁵

³² IRC Section 401(l)(3)(B); Treas. Reg. Section 1.401(l) 3(b).

³³ Treas. Reg. Section 1.401(l) 3(c)(2)(ix); Notice 92 32 (1992 2 CB 362).

³⁴ IRC Section 401(l)(4)(B); Treas. Reg. Sections 1.401(l) 1(c)(18), 1.401(l) 3(b)(3).

³⁵ Treas. Reg. Section 1.401(l) 3(b)(5).

If benefits commence prior to or after SSRA, the .75 percentage point factor is reduced or increased depending on the age at which benefits commence and the participant's SSRA. See tables above for the tables used to adjust the .75 percentage point factor in the MOA.³⁶

Offset Level

The offset level is the dollar limit specified in the defined benefit offset plan on the amount of each participant's final average compensation taken into account in determining the offset.³⁷

For defined benefit offset plans, the offset level must meet one of the following requirements:³⁸

- The offset level for all participants is a single dollar amount that does not exceed the greater of \$10,000 or one half of the covered compensation of an individual who attains SSRA in the calendar year in which the plan year begins.
- The offset level for all participants is a single dollar amount that is greater than the amount determined in above, that does not exceed the participant's final average compensation, and that satisfies special demographic requirements, and the .75 percent factor is adjusted.
- The offset level for each participant is the participant's covered compensation.
- The offset level for each participant is a uniform percentage (greater than 100 percent) of each participant's covered compensation that does not exceed the participant's final average compensation, and the .75 percent factor is adjusted.
- The offset level for all participants is a single dollar amount (described above), and the .75 percent factor in the MOA is reduced to the lesser of an adjusted factor or 80 percent of the otherwise applicable factor.

Average Annual Compensation

Average annual compensation means the participant's highest average annual compensation for one of the following:

- Any period of at least three consecutive years
- If shorter, the participant's full period of service

For this purpose, a participant's compensation history may begin at any time, but must be continuous, be no shorter than the averaging period, and end in the current plan year.³⁹

Covered Compensation

Covered compensation means the average (without indexing) of the TWBs for the 35 calendar years ending with the year an individual attains SSRA. A defined benefit plan can provide for permitted disparity on the basis of each individual employee's covered compensation. Covered compensation does not refer to the amount of compensation that the employee actually earned, but reflects the ceiling for Social Security wages, i.e., the TWB, over the years. See the tables in the section entitled "2007 Covered Compensation Tables" at end of this chapter.

³⁶ Treas. Reg. Section 1.401(l) 3(e).

³⁷ Treas. Reg. Section 1.401(l) 1(c)(23).

³⁸ Treas. Reg. Section 1.401(l) 3(d).

³⁹ IRC Section 401(l)(5)(C); Treas. Reg. Sections 1.401(a)(4) 3(e)(2)(i), 1.401(l) 1(c)(2).

A plan may use an amount of covered compensation for a plan year earlier than the current plan year provided that the earlier plan year is the same for all employees and is not earlier than the plan year that begins five years before the current plan year.

Example. In 2007, Cruise Corp. adopted a defined benefit excess plan with a calendar plan year. For the 2007 through 2012 plan years, the plan's integration level for each participant was based upon the 2007 covered compensation table and was permissible. However, the integration level must be changed for the 2013 plan year and may be the covered compensation table for the 2008 or any later plan year.⁴⁰

Although an increase in covered compensation will result in a smaller benefit at retirement, a participant's accrued benefit may not be reduced because of the increase in covered compensation.⁴¹

Defined Benefit Plan Uniform Disparity Rule

With respect to qualified retirement plans that provide for permitted disparity, the disparity for all participants under the same plan must be uniform.⁴²

The disparity provided under a defined benefit excess plan is uniform only if the plan uses the same BBP and the same EBP for all participants with the same number of years of service.

The disparity provided under a defined benefit offset plan is uniform only if the plan uses the same gross benefit percentage and the same offset percentage for all participants with the same number of years of service. However, an exception to these rules applies if the plan provides that, in the case of an employee for whom no FICA taxes are required to be paid, employer provided benefits are determined with respect to the participant's total average annual compensation at the EBP or gross benefit percentage applicable to a participant with the same number of years of service.⁴³

Top-Heavy Plan Restrictions

A top-heavy defined benefit plan must provide each participant who is a non key employee with a minimum annual retirement benefit, and a top-heavy defined contribution plan must provide each participant who is a non key employee with a minimum annual contribution. A top-heavy plan cannot take into account Social Security benefits or contributions to satisfy these minimum requirements.⁴⁴

Effect of Plan Termination

If a defined benefit plan providing for permitted disparity is terminated and the plan assets exceed the present value of the accrued benefits, the use of the excess funds to increase benefits under the plan must not

⁴⁰ IRC Section 401(l)(5)(E); Treas. Reg. Section 1.401(l) 1(c)(7); Rev. Rul. 2003 124 (2003 49 I.R.B. 1); Notice 89 70 (1989 1 CB 730).

⁴¹ IRC Section 411(d)(6).

⁴² Treas. Reg. Sections 1.401(l) 2(a)(4), 1.401(l) 3(a)(4).

⁴³ Treas. Reg. Sections 1.401(l) 3(c)(1), 1.401(l) 3(c)(2)(vii).

⁴⁴ IRC Section 416(e); Treas. Reg. Section 1.416 1, Q&A M 11.

violate the permitted disparity rules.⁴⁵ The termination of a qualified retirement plan may not discriminate in favor of HCEs.⁴⁶

2007 Covered Compensation Tables

The following are tables of covered compensation under IRC Section 401(l)(5)(E) for the 2007 plan year. The tables are used for determining contributions to defined benefit pension plans and permitted disparity.⁴⁷

2007 Covered Compensation Table

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	2007 Covered Compensation Table
1907	1972	\$ 4,488
1908	1973	4,704
1909	1974	5,004
1910	1975	5,316
1911	1976	5,664
1912	1977	6,060
1913	1978	6,480
1914	1979	7,044
1915	1980	7,692
1916	1981	8,460
1917	1982	9,300
1918	1983	10,236
1919	1984	11,232
1920	1985	12,276
1921	1986	13,368
1922	1987	14,520
1923	1988	15,708
1924	1989	16,968
1925	1990	18,312
1926	1991	19,728

⁴⁵ Rev Rul 80 229 (1980 2 CB 133).

⁴⁶ Treas. Reg. Section 1.401(a)(4) 5(a)(1).

⁴⁷ Rev. Rul. 2003 124 (2003 49 I.R.B. 1).

2007 Covered Compensation Table (continued)

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	2007 Covered Compensation Table
1927	1992	21,192
1928	1993	22,716
1929	1994	24,312
1930	1995	25,920
1931	1996	27,576
1932	1997	29,304
1933	1998	31,128
1934	1999	33,060
1935	2000	35,100
1936	2001	37,212
1937	2002	39,444
1938	2004	43,992
1939	2005	46,344
1940	2006	48,816
1941	2007	51,348
1942	2008	53,820
1943	2009	56,232
1944	2010	58,608
1945	2011	60,960
1946	2012	63,276
1947	2013	65,556
1948	2014	67,680
1949	2015	69,732
1950	2016	71,664
1951	2017	73,524
1952	2018	75,300
1953	2019	77,004
1954	2020	78,660

(continued)

2007 Covered Compensation Table *(continued)*

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	2007 Covered Compensation Table
1955	2022	81,780
1956	2023	83,280
1957	2024	84,684
1958	2025	86,004
1959	2026	87,264
1960	2027	88,464
1961	2028	89,604
1962	2029	90,660
1963	2030	91,704
1964	2031	92,700
1965	2032	93,612
1966	2033	94,440
1967	2034	95,160
1968	2035	95,760
1969	2036	96,252
1970	2037	96,612
1971	2038	96,912
1972	2039	97,188
1973	2040	97,404
1974 & later	2041 & later	97,500

2007 Rounded Covered Compensation Table

Year of Birth	Covered Compensation
1937	39,000
1938–1940	45,000
1941	48,000
1942	51,000
1943	54,000
1944	57,000
1945–1946	60,000
1947	63,000
1948	66,000
1949–1950	69,000
1951	72,000
1952–1953	75,000
1954–1955	78,000
1956–1957	81,000
1958–1959	84,000
1960–1962	87,000
1963–1964	90,000
1965–1968	93,000
1969–1972	96,000
1973 and later	97,500

Chapter 8

Internal Revenue Code Section 401(k) and Safe-Harbor 401(k) Plan Design

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This chapter discusses the peculiarities of the Internal Revenue Code (IRC or the Code) Section 401(k) plan (401(k) plan) and the special rules that apply to these plans with regard to nondiscrimination and other significant design issues. We also cover the special subcategory of safe-harbor 401(k) plans and how they can be designed to avoid some of the difficulties of the otherwise required nondiscrimination rules. It is intended that this be a general explanation and not a detailed explanation of the many provisions, rules, and complexities of 401(k) plans.

401(k) Arrangements

401(k)—A Feature, Not a Plan

In light of the constant attention given to 401(k) plans by the media, including the financial press, it may come as a surprise that there really are no such things as 401(k) *plans* (even though everyone—including the Internal Revenue Service (IRS)—refers to them this way). In fact, a 401(k) plan would be much better referred to as a *feature* that is added to either a profit-sharing plan (most frequently) or a stock bonus plan (less frequently) or a pre-ERISA (meaning, before the Employee Retirement Income Security Act of 1974; that's before 1974!) money-purchase plan that was grandfathered when ERISA was passed. The latter is so rare that I have never seen one and do not know anyone who has. We will assume, in this chapter, that the 401(k) feature is always part of a profit-sharing plan.

Cash or Deferred Arrangements

If you look up Internal Revenue Code (IRC or the Code) Section 401(k), you will find that it actually addresses “cash or deferred arrangements,” which we refer to as a *CODA*. A *CODA* is simply an option that is provided to a participant in a retirement plan under which the individual has the right to elect either to take their income from their employer in the form of *cash* wages (most common), or, if they are so inclined, to *defer* wages directly into the retirement plan on a pretax basis. Neither federal nor state income taxes are paid on wages

that are deferred into the 401(k) part of the retirement plan. Note, however, that Social Security taxes (including Medicare) are paid on amounts deferred into a 401(k) program.

General Requirements of 401(k) Plans

Nondiscrimination Testing

401(k) plans are subject to what is called the actual deferral percentage test (ADP test). This test is used to limit the deferrals allowed by highly compensated employees (HCEs). The employer determines the percentage of compensation deferred by each participant under the 401(k) arrangement. The ADP test compares the average deferral rates of the nonhighly compensated employees (NHCEs) with the average deferral rates of the HCEs. If the HCE rate exceeds the NHCE rate by more than a permitted range, the plan will not meet the requirements of the test.

It is possible for a plan to be designed to automatically meet the requirements of the ADP test. In fact, a plan is deemed to pass the ADP test if it satisfies the requirements of what is known as a *safe-harbor 401(k) plan*, which is described in IRC Section 401(k)(12). We will discuss these safe-harbor provisions later in the chapter.

We should note here that there is also something called the actual contribution percentage test (ACP test), a special nondiscrimination test. The portion of a plan that consists of after tax employee contributions and/or matching contributions is subject to its own testing. The ACP test is applied to these contributions under IRC Section 401(m). Since matching contributions are most often found with a 401(k) feature, the 401(m) testing (ACP) often goes hand in hand with 401(k) plans and ADP testing.

Vesting

All elective deferrals (that is, the contributions made by the employees out of their otherwise payable wages) must be 100 percent vested at all times in a 401(k) plan.

Eligibility to Defer

An employee cannot be required to complete more than one year of service as a condition of participation in a 401(k) program. This is more restrictive than the general rule that allows for up to a two-year requirement in plans that do not have a 401(k) feature.

Distribution Restrictions

The elective deferrals made to a 401(k) plan are not as readily available for distribution as other funds in qualified retirement plans as a result of special restrictions that apply to 401(k) money. For example, the money cannot be paid out prior to age 59½ as an in-service distribution (but it can, of course, be paid out in the event of death, disability, or termination of employment).

Contingent Benefit Rule

This rule provides that no other employer-provided benefits, except a matching contribution, can be conditioned upon whether the employee elects to participate in the 401(k) arrangement. Thus, the only *arm twisting* that can be done to employees to get them to participate in the 401(k) plan is to offer them a match that is conditioned on their contributing their own funds to the plan. The contingent benefit rule prevents the employer from using the enticement of other employer-provided benefits in the plan that includes the section

401(k) arrangement (other than the noted matching contributions), or in another qualified plan maintained by the employer, or health benefits, vacation, life insurance, loans, or nonqualified deferred compensation benefits.

Who can establish a 401(k) plan?

Any regular business, whether established as a corporation, partnership, sole proprietorship, LLC, or LLP is free to establish a 401(k) plan. The provisions of the 401(k) can and do apply to self-employed individuals and partners as well as those employees who actually receive Form W-2, Wage and Tax Statements.

A governmental entity may not maintain a 401(k) arrangement if the entity is a state or local government; a political subdivision of a state or local government; or an agency or instrumentality of such state, local government, or political subdivision. There is an exception for governmental employers who maintained a 401(k) arrangement that had been in existence as of May 6, 1986.

Note that nongovernmental tax-exempt organizations are now permitted to establish and maintain 401(k) arrangements, without limitation. Thus, a charitable organization under 501(c)(3) may establish a 401(k) arrangement if it so desires. For the record, however, there was a prohibition in effect from 1987 to 1996 prohibiting these organizations from establishing 401(k) plans during that time.

Lastly, IRC Section 401(k)(4)(iii) expressly allows an Indian tribal government to establish a 401(k) arrangement under the rules that apply for nongovernmental tax-exempt organizations.

401(k) Deferral Limits

IRC Section 402(g) sets a limit on the amount of elective deferrals that may be excluded from gross income by an individual in a single calendar year. This limit is applied on an individual taxpayer basis and applies across multiple employers (if there are multiple employers). Thus, a single taxpayer cannot exceed the annual maximum limit by contributing to two plans with two different employers. The amount deferred is reported on the Form W-2 of the employee and that is how a contribution in excess of the 402(g) limit will be caught by the IRS computers.

In 2004, the maximum regular limit for what could be deferred under a 401(k) plan was \$13,000. This amount increased by \$1,000 each year for the next two years under a statutory provision, so that it was \$14,000 in 2005 and \$15,000 in 2006. Thereafter, it rises with cost of living adjustments, and in 2007 it has risen to \$15,500.

Catch-Up Contributions

An individual who is at least 50 years old and who participates in a 401(k) plan has an additional amount available that can be deferred beyond the numbers noted above. These are the catch-up contribution rules under IRC Section 414(v) that allow an individual to exclude from his or her gross income elective deferrals that exceed the IRC Section 402(g)(1)(A) limit, up to an annual catch-up limit. These catch-up amounts were added by the 2002 tax law enacted by Congress.

Practice Pointer: These catch-up contributions also work to increase the overall maximum that a participant could otherwise receive in a given year from a retirement plan. Only elective deferrals that satisfy the catch-up rules provide for this increase. Thus, it is only through having a 401(k) feature that a plan may exceed the otherwise allowable maximum contribution under IRC Section 415 limit (currently \$45,000 per year in 2007).

In 2004, the additional catch-up contribution allowed was \$3,000. That amount increased by \$1,000 in each of the next two years under a statutory provision, so that in 2005, the catch-up amount was \$4,000 and in 2006 the catch-up amount climbed to its statutory scheduled maximum of \$5,000. Further increases will be provided under a cost of living adjustment, but for 2007 the catch-up amount remains at \$5,000. If a participant is over age 50 in 2007, he would be able to get a maximum IRC Section 415 maximum of \$45,000 (currently) *plus* an additional \$5,000 for the catch-up which brings the overall maximum allocation to \$50,000 in 2007.

Discrimination Testing Details

The ADP test (or, in its place, the safe-harbor 401(k) option) is the exclusive means of showing the 401(k) arrangement satisfies the nondiscrimination requirements of the law.

The ADP is determined by averaging the deferral percentages separately calculated for the eligible employees in the 401(k) arrangement. An employee's deferral percentage is the percentage of his compensation that has been deferred to the plan through the 401(k) arrangement (not including catch-up contributions).

One ADP is calculated for the eligible employees who are in the HCE group, and another ADP is calculated for the eligible employees who are in the NHCE group. The purpose of the ADP test is to set a limit on the ADP for the HCE group. To pass the test, the ADP of the HCE group must satisfy the 1.25 test or the 2-percent spread test.

1.25 Test

This test is satisfied if the ADP of the HCE group does not exceed 1.25 times the ADP of the NHCE group. For example, if the ADP of the NHC group is 4 percent, the ADP of the HCE group would be limited to 1.25×4 percent, or 5 percent.

2 Percent Spread Test

This test is satisfied if the ADP of the HCE group is not more than two percentage points greater than the ADP of the NHC group, and the ADP of the HCE group is not more than twice the ADP of the NHC group. In other words, to arrive at the limit for the HCE group, add 2 percent to the NHC group's percentage or double that percentage, whichever produces the smaller result.

Rule of Thumb

If the ADP of the NHCEs is 2 percent or less, the maximum allowed for the HCEs would be 200 percent of the NHCE level. If the ADP of the NHCEs is between 2 percent and 8 percent, the maximum allowed for the HCEs would be the ADP of the NHCEs plus 2 percent. And if the ADP of the NHCEs was 8 percent or greater, the maximum allowed for the HCEs would be the ADP of the NHCEs times 1.25. The chart would look like this:

If ADP of NHCEs Is:	Then Maximum ADP for HCEs Is:
0–2%	200% of NHCE ADP
2–8%	ADP of NHCE <i>plus</i> 2%
8% or more	125% of NHCE ADP

Choices in ADP Testing

There are a number of choices to be made in how to apply the ADP testing. One choice is whether data from the current year or the prior year for NHCEs is going to be used to determine what the HCEs can defer in the current year. These two choices are known as *prior year testing* or *current year testing*. In either case, you are really testing the current year for the HCEs, but either using prior-year or current-year data as they relate to calculating the ADP of the NHCEs. The chosen methodology used must be specifically provided in the plan document, and there are rules about making changes from one method to another. The default method is prior-year testing, and switching from prior year to current year is always permitted.

To change from current year to prior year, the plan must have used current year for at least the five preceding plan years (or all prior years if the plan has been in existence for fewer than five years).

We failed! What now?

If the ADP (or the ACP) test is failed, corrective action must be taken during the *applicable correction period* provided by the IRS regulations. This period is the plan year of 12 months *following* the close of the plan year in which the failure has occurred. Failure to correct an ADP violation can result in the plan being disqualified.

The correcting methodology is relatively complex and beyond the scope of our discussion here, but, unless the employer is going to make additional contributions for the NHCEs, it involves disgorging back to the HCEs enough of their deferrals so that the plan is deemed to pass the ADP test. It is particularly interesting to note that the methodology now required by the IRS, when used, results in a situation in which the plan *still does not pass the mathematical ADP test*, but if done in accordance with the IRS guidance, the plan will be *deemed* to have met the ADP test. The distributions that must be made also include a share of the allocable earnings for the plan year, calculated using any reasonable method. For 2006 plan years, it is also required that an additional adjustment must be made for the earnings attributable to the *gap period*, which is the period of time from the end of the plan year in which the failure occurred to the actual time of the distribution of the excess amounts to the HCEs. If the allocable earnings is a loss, the amount actually distributed will be less than the excess amount. Starting in the 2008 plan year, this *gap period* income calculation is no longer required to be made (or distributed) as a result of new legislation passed in 2006 (The Pension Protection Act of 2006 – “PPA”).

Tax Treatment of Corrective Distribution

A corrective distribution of elective deferrals is fully taxable since amounts distributed to correct an ADP test violation are attributable to pretax contributions. (A corrective distribution under the ACP test might not be fully taxable since employee contributions may have been after-tax contributions). Allocable income distributed with either ADP or ACP violation distributions will also be taxable.

Previously, the timing of when a corrective distribution was made affected the year in which the income was included for the individual participant. Different rules were provided for corrective distributions that were made within the first two and one-half months of the correction period than for corrective distributions

that were made after the first two and one-half months of the correction period. In addition, the employer is liable for an excise tax when corrective distributions are made after the first two and one-half months of the correction period.

Distributions Made in the First Two and One-Half Months of the Correction Period

Previously, if the distribution was made in the first two and one-half months of the 12-month correction period, the taxable amount was generally included in the income for the taxable year of the participant that *precedes* the taxable year in which the distribution occurred. This could require that the individual receiving the distribution might have to file an amended income tax return since the amount is going to be attributed to a prior tax year and it is possible that the tax return for that year has already been filed. As a result of changes included in the Pension Protection Act of 2006, corrections made for plan years beginning on or after January 1, 2008 will be reported only in the year in which they are made. There will no longer be a requirement that correcting distributions be attributable to a prior tax year (and thus, there no longer is the possibility that amended tax returns will have to be filed to reflect a later occurring correcting distribution). However, note the delayed effective date; the prior rules are still in effect until those 2008 years.

Distributions Made After the First Two and One-Half Months of the Correction Period

If the excess amounts are distributed *after* the first two and one-half months of the correction period, the amount includible in income is taxable for the year in which the distribution is made. In addition, if distributions are made after the first two and one-half months of the correction period, the *employer* is liable for an excise tax on the amount distributed. These rules dealing with distributions *after* two and one-half months continue to be the same under PPA; when the new PPA rules are effective, the significant difference between making the distribution within the two and one-half month period or later, will be the excise tax payable on the later distribution (see discussion to follow).

Employer Excise Tax for Corrective Distributions Made After Two and One-Half Months

If corrective distributions are made after the first two and one-half months of the correction period, the employer (not the HCE) is liable for an excise tax under IRC Section 4979. The amount of the excise tax is equal to 10 percent of the amount of the excess contribution (determined before the adjustment for allocable earnings). The employer is liable for paying the excise tax and does so by Form 5330. The due date for payment is the last day of the fifteenth month following the close of the plan year.

Reporting the Corrective Distributions Using Form 1099-R

The IRS Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., is used to report corrective distributions. The form for the current calendar year of the distribution must be used, even if the distribution is taxed in a prior year. For example, a distribution that occurs on March 1, 2007, to correct a violation of the ADP test for the plan year ending December 31, 2006, is reported on the 2005 Form 1099-R, even though the distribution is included in income for 2006. Once the new PPA rules are implemented, this retroactive taxation issue disappears (see discussion above).

Another Way to Fix a Failed Test: Qualified Nonelective Contributions

Rather than refunding deferrals to HCEs, it is possible for an employer to *fix* a failed ADP (or ACP) test by the use of qualified nonelective contributions (QNECs). These are simply additional *employer contributions* made to the NHCEs which act as a *booster* in bringing up the ADP or ACP of the NHCEs. Of course, this requires that the employer would be willing to contribute its own additional dollars rather than refund money to the HCEs. A complete discussion of how QNECs are calculated is beyond the scope of this discussion.

Safe-Harbor 401(k) Plans

The IRC provides an alternative to having to do all this testing and comparing of contributions made by HCEs against the contributions made by the NHCEs. IRC Section 401(k)(12) provides that if a 401(k) plan satisfies the conditions in that section, the ADP test is deemed satisfied. A 401(k) plan that satisfies the requirements of IRC Section 401(k)(12) is known as a safe-harbor 401(k) plan. To qualify for the ADP safe harbor, the 401(k) plan must satisfy the following conditions:

1. A safe-harbor contribution requirement
2. A vesting requirement
3. Withdrawal restrictions
4. An annual notice requirement

Safe-Harbor Contribution Requirement

This requirement is met if the employer makes either a safe-harbor matching contribution or a safe-harbor nonelective contribution to satisfy the safe-harbor contribution requirement. The safe-harbor contributions are required to be provided to NHCEs, but do not have to be provided to HCEs if the plan is so designed.

The matching contribution must be no less than a 100-percent match on the first 3 percent of compensation deferred, plus a 50-percent match on the next 2 percent of compensation deferred. Thus, if an employee defers at least 5 percent of his or her compensation, the employer match will max out at an amount equal to 4 percent of that individual's compensation. As an alternative to the matching contribution, a safe-harbor nonelective contribution may be adopted to meet the safe-harbor contribution requirement. A nonelective contribution will satisfy the ADP safe-harbor contribution requirement if it equals at least 3 percent of the employee's compensation. As with the match, the nonelective contribution need only be provided to the eligible NHCEs. However, the plan may provide that the HCEs also receive the nonelective contribution allocation. Note that this is not a match; an eligible NHCE must receive the allocation of the nonelective contribution regardless of whether he chooses to make deferrals under the IRC Section 401(k) arrangement. Some employers prefer the nonelective contribution because it does not discriminate among the employees based on their own financial circumstances and their individual abilities to defer into a 401(k) arrangement. In addition, this safe-harbor provision will also meet the minimum contribution requirement for a plan that is *top heavy*.

There can be no exception to an eligible employee's right to accrue the minimum contribution. The plan cannot require that the eligible employee complete a minimum number of hours of service for the plan year (e.g., 1,000 hours) or be employed on the last day of the plan year in order to be entitled to the minimum matching contribution or the minimum nonelective contribution. The IRS guidance provides that the safe-harbor contribution must be provided to all NHCEs who are eligible employees under the IRC Section 401(k) arrangement.

Safe-Harbor Vesting Requirement

The safe-harbor contribution must be 100-percent vested at all times, regardless of the employee's length of service. Amounts that are not part of the safe-harbor contribution can be subject to the normal vesting rules applicable to qualified plans.

Safe-Harbor Withdrawal Restrictions

Participant withdrawals of the ADP safe-harbor contributions are restricted. No hardship withdrawals are permitted with respect to safe-harbor employer contributions.

Annual Notice Requirement

A safe-harbor 401(k) plan must provide the eligible employees an annual written notice which describes the employee's rights and obligations under the arrangement. The annual notice requirement was a necessary element to obtaining the Department of the Treasury's support for the legislation that created the safe-harbor option. With the elimination of the ADP test, the Treasury was concerned that an employer would have less incentive to encourage enrollment by the NHCEs. In fact, where the safe-harbor matching contribution formula is provided, an employer might prefer lower enrollment, so its matching contribution costs are reduced. The annual notice requirement will serve as a reminder to the employees of the advantages of participating in the 401(k) arrangement and how they make (or modify) deferral elections.

Comment on Employee Direction of Investments in a 401(k) Plan

Though most 401(k) plans provide for employee direction of some or all of the plan investments, this is not required by law. It is perfectly permissible for a plan to provide that some or all of the money in the plan, including the employee elective deferrals, are invested only under the direction of the trustees, and the employee has no election with regard to where the funds are invested. A discussion of the pros and cons of employee-directed investments is beyond the scope of this presentation, but be aware that there are well-reasoned arguments for not allowing employee investment direction and that plans that are written that way are completely within the scope of the law.

Chapter 9

Defined Contribution Cross-Tested, General Tested Plan Design

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If a defined contribution plan is not designed to automatically pass the various Internal Revenue Service (IRS) nondiscrimination tests, then it must be tested under an extremely complex and almost mysterious set of IRS rules, known as the general test for nondiscrimination, often referred to as the general test. The general test rules offer a multitude of methodologies to prove that your plan, in operation, is nondiscriminatory (as defined by the IRS). A complete analysis of the general nondiscrimination rules is well beyond the scope of this chapter; some suggest that they are well beyond the scope of comprehension. Nevertheless, this chapter reviews the important aspects of this approach to plan design for the small business retirement plan so the practitioner will be aware that there are many options for creative plan design which a competent qualified plan consultant will be able to suggest.

A good friend of mine, who is, perhaps, the world's expert on nondiscrimination testing, has often said that under the extremely complex and voluminous IRS rules, every plan will pass the nondiscrimination rules. It is simply a matter of knowing how the rules work, and then testing and retesting the plan under the large number of methods with their enormous number of alternatives, until either the plan passes the tests, or the client runs out of money to pay the consultant's fees!

What Is This All About?

If the truth be told, it is all about *discrimination*—not the illegal kind, but the absolutely legal and permissible kind that is sanctioned by the United States Government in the guise of the IRS. If we look at the design of a retirement plan for what we generally refer to as a *small business*, we find that the owners of the business are very often particularly interested in receiving a relatively significant benefit from the retirement plan, while keeping the cost (and, thus, the benefits) for the rank-and-file employees at a minimum cost. Some might raise an eyebrow over a plan under which Dr. Bigbucks (who earns \$225,000 per year) gets an allocation for the plan year of \$45,000 while his hardworking but modestly paid (\$30,000 per year) assistant (who is the only full-time employee; all others on the payroll never work more than 18 hours a week, every

week) gets an allocation of \$1,500. Given the right *demographics* (the ages of the doctor and the assistant being “good”), it is perfectly possible and permissible that such a design would be acceptable (that is, it will pass the general test for nondiscrimination). Is it *discriminatory*? Of course it is! The good news is that it is not *impermissibly discriminatory*, and that is what this chapter is all about.

The nondiscrimination rules are a complex web of interrelated rules covering various sections of the Internal Revenue Code (IRC or the Code). These include the coverage rules under IRC Section 410(b), the nondiscrimination rules under IRC Section 401(a)(4), and the definition of compensation under IRC Section 414(s).

Rate Group Testing for Defined Contribution Plans (the General Test)

Rate group testing is a more precise term for the IRS's general nondiscrimination test in Treasury Regulations Section 1.401(a)(4)-2(c). If a defined contribution plan's design does not fit into one of the safe-harbor categories that were discussed in an earlier chapter in this book, then the plan is subject to this rate group testing. In the most basic terms, this rate group testing is simply a method of showing that the allocations of contributions (that is, the plan benefits) are nondiscriminatory. This is done by analyzing these things called *rate groups*, and showing that each rate group can satisfy certain provisions of the tests. Here, each rate group must satisfy one of the coverage tests under IRC Section 410(b).

Determining Rate Groups

Since we must test *each* rate group, we will need to figure out just what a rate group is. Rate group testing requires annual testing and looks at the individual participants in the plan and the benefits they are getting under the plan. To determine our rate groups, we must express each participant's allocation under the plan in the form of either an *allocation rate* or an *equivalent benefit accrual rate* (also known as an EBAR), applying the same method to everyone under the plan.

The allocation rate just referred to is simply the amount of dollars allocated (including contributions and forfeitures). So what is an EBAR, and how does it work?

Equivalent Benefit Accrual Rate—Cross-Testing

If we were to take the dollars allocated to an individual's account for a given year and use some mathematical process to project those dollars forward with earnings to the participant's normal retirement age, and then convert that accumulated amount to a monthly benefit that could be provided to them for the rest of their life, we will have covered the concept of calculating an EBAR. In effect, we are converting the dollar allocation under the defined contribution plan to a monthly benefit payable at retirement age for this participant. By dividing that monthly benefit by the compensation of the participant, we have just calculated an equivalent benefit accrual rate. The EBAR is basically the determination of how much the current allocation in a defined contribution plan would buy (as a percentage of the participant's current compensation) as a benefit at retirement on a defined benefit basis.

The use of EBARs is referred to as *cross-testing*, because it is converting a defined contribution allocation to a defined benefit concept and then testing the benefits provided to the participants on a benefits basis. We are testing defined contribution dollars on a defined benefit basis—thus, cross-testing!

The Basics of Cross-Testing

Cross-testing is just a different way of performing the rate group testing. If we take each and every participant in the plan and project their allocation to retirement age to calculate their EBAR, we can then order the employees from highest to lowest based on the size of their EBAR.

The most significant factor of the determination of EBARS is that the younger the participant is (that is, the further away from normal retirement age they are), the larger will be their EBAR per dollar of allocation. The IRS provides rules for how to do the math that converts current dollars to EBARS. Probably the most significant item is the interest rate that can be used to project these allocations forward to retirement age.

The IRS allows us to use a range of rates from 5½ percent to 8½ percent to project the values at retirement. The effect of a higher interest rate on compound interest over time is to give significantly higher values at the accumulation point (retirement age). A contribution of \$1 allocated to a 25-year-old growing at 8½ percent to age 65 will be much, much larger than \$1 allocated to a 45-year-old growing at that same rate to age 65. Thus, younger participants will get higher values at age 65 (their EBARS will be much greater) per dollar of allocation than will older participants.

It is this mathematical process that works favorably to allow our Dr. Bigbucks to get his \$45,000 allocation while his assistant gets a meager \$1,500. The doctor's allocation of \$45,000 is 20 percent of his compensation of \$225,000; but the assistant's \$1,500 is only 5 percent of her \$30,000 compensation. Yet, when we compare the value of those contributions projected to retirement age, the 25-year-old assistant's contribution is actually more valuable as a percentage of her pay (on a projected defined benefit basis due to the enormous effect of compound interest over a 40-year period) than is the \$45,000 allocation to our 62-year-old doctor. Mathematically, and using the IRS regulations, we can show that the assistant's current 5 percent contribution is more valuable than the doctor's 20 percent current contribution, when both are projected forward to retirement age.

And that is the magic of *cross-testing*.

Figuring Out Your Rate Groups Using EBARS

Now that we know the basics of calculating EBARS, we can return to the determination of our rate groups. We have calculated an EBAR for each and every participant in the plan. We can now rank the participants by their EBAR (from largest EBAR to smallest). We want to pay particular attention to where each and every highly compensated employee (HCE) appears in our ranking. The reason for this is that the number of rate groups is exactly equal to the number of HCEs in the plan. Each and every HCE forms his or her own rate group, and the members of that group consist of that HCE and every other participant (including other HCEs) who have an EBAR equal to or greater than that HCE's EBAR.

This does mean that participants can and will be in more than one rate group. For example, if HCE1 has a smaller EBAR than HCE2, then HCE2 (and all other participants who have an EBAR greater than HCE1) will be in HCE1's rate group. In addition, all participants who have an EBAR greater than HCE2's EBAR will be in the rate group of HCE2, even though they were already in the rate group of HCE1. The rate groups will become smaller in number of both HCEs and nonhighly compensated employees (NHCEs) as the EBARS increase. By the way, if two HCEs have the same EBAR, we only need to test their rate groups as a single rate group since the members of each of their rate groups will be identical, and if one rate group passes, then so will the other.

Example. Assume a profit-sharing plan with 3 HCEs that is a cross-tested plan. The EBARS for the HCEs are 5.47 percent for HCE1, 8.89 percent for HCE2, and 10.66 percent for HCE3.

There will be three rate groups to test, one for each of the HCEs. The 10.66 percent rate group includes HCE3 and all NHCEs with an EBAR equal to or greater than 10.66 percent. The 8.89 percent rate group includes HCE2 and HCE3 and all NHCEs with an EBAR equal to or greater than 8.89 percent. Last, the 5.47 percent rate group includes all three HCEs and all NHCEs with an EBAR equal to or greater than 5.47 percent.

If there are NHCEs with EBARS lower than 5.47 percent, they will *not* be in any rate group, and that is fine.

Example. The facts are the same as in the preceding example, except that the HCE2's EBAR also was 10.66 percent. Now, there will be only two rate groups to test, the 10.66 percent rate group which includes HCE2 and HCE3, and the 5.47 percent rate group which includes all three HCEs.

Rate Groups and Coverage Testing

Now that we know which participants are in our rate groups, we can do our rate group testing. Every rate group must satisfy the coverage requirements of IRC Section 410(b). There is a choice of two tests, the passing of either one of which will mean that our rate group passes the nondiscrimination testing. For the plan as a whole to pass, all the rate groups must pass one of these tests. Those tests are known as the *ratio percentage test* and the *average benefits test*. The rate groups do *not* have to all pass the same test; it is enough that each rate group pass either one of the tests.

The Ratio Percentage Test

In order to pass this test, we will calculate something called the coverage ratio. In order to pass, the coverage ratio for the rate group must be at least 70 percent. We start by assuming that the employees who are in the rate group are the only employees in the plan. We now calculate *two* ratios, namely, the NHCE ratio and the HCE ratio. A ratio has a numerator and a denominator. The NHCE ratio for the rate group has as its numerator the number of NHCEs who are included in the rate group under discussion, and the denominator is the number of *all* NHCEs (other than certain excludable employees such as those who have not yet met the age and service conditions for eligibility in the plan, union employees, and employees who terminated during the plan year with fewer than 500 hours of service). Note that the denominator will pick up those employees who have met the age and service requirement even if they are otherwise excluded from the plan by employment classification or specifically excluded by name.

The HCE ratio is calculated in the same way; it has a numerator of those HCEs who are included in the rate group and a denominator of all HCEs of the employer.

To calculate the coverage ratio, you take the NHCE ratio calculated above and divide by the HCE ratio. If this is at least 70 percent, the rate group passes the ratio percentage test.

A way to say the formula in English is that the percentage of NHCEs covered in the rate group must be at least 70 percent of the percentage of HCEs covered in the rate group. For example, if your rate group covers one out of two HCEs (which is 50 percent), then you would have to cover 70 percent of that percentage, which would mean having to cover 35 percent of the NHCEs in the rate group.

The Average Benefits Test

If any rate group cannot pass the ratio percentage test as described above, then it must pass the average-benefits test in order for the plan as a whole to be nondiscriminatory under the IRS regulations.

The average benefits test has two distinct parts, both of which must be passed:

- The nondiscriminatory classification test
- The average benefits percentage test

The Nondiscriminatory Classification Test

The first part of the test is to show that the rate group passes this nondiscriminatory classification test. This is done in the same manner as the ratio percentage test shown above, but with a different passing level. To pass the nondiscriminatory classification test, the coverage ratio must be at least equal to the midpoint between the applicable safe-harbor percentage and unsafe-harbor percentage in Treasury Regulations Section 1.410(b)-4 (or the plan's actual ratio percentage, if less).¹

The coverage ratio needed to pass the test will depend on what percentage of the work force (other than excludable employees) is made up of NHCEs (known as the *NHCE concentration percentage*). The required coverage ratio 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, do not go any further. The rate group fails the average benefits test, and allocations will need to be increased for some or all of the NHCEs in order to pass this test. If every rate group passes the nondiscriminatory classification test, then the rate group test is satisfied only if the plan satisfies the average benefits percentage test, as described below.

The Average Benefits Percentage Test

The second part of the test is to show that the average benefits percentage for the employer's plans is at least 70 percent. This step is performed at the employer level, taking into account all plans maintained by the employer that are required to be included in the average benefits percentage.

To do this test, we need to have all the EBARS for all the employees calculated (other than excludable employees for coverage testing purposes), regardless of whether the NHCE benefits from any rate group being tested under the plan or even is a participant in the plan. Separate the HCE numbers from the NHCE numbers. Then, calculate the sum of the NHCE EBARS and divide by the number of NHCEs in the calculation (here we are determining the average EBAR of the NHCEs). Express the result as a percentage.

Now do the same for the HCEs. Determine the average of their EBARS.

Divide the percentage for the NHCEs by the percentage for the HCEs. The result is the plan's average-benefits ratio. If the average benefits ratio is at least 70 percent, and each rate group has passed the nondiscriminatory classification test as described above, the plan satisfies this rate group testing method, the average benefits test.

Gateway Testing

Beginning in 2002, if a plan is going to rely on cross-testing to meet the nondiscrimination rules, it must also pass a gateway test as a precondition to using the cross-testing methodology.

The gateway provisions provide for a gateway contribution test. Under this test, the lowest permissible allocation rate for any NHCE who benefits under the plan is one-third of the highest allocation rate for any

¹ See Treas. Reg. Section 1.401(a)(4)-2(c)(3)(ii)

HCE who benefits under the plan. This is generally called the *one-third test*. However, if each NHCE receives an allocation that is no less than 5 percent of their compensation, the gateway is deemed satisfied. This is referred to as the 5 percent test. Thus, for plans that generally provide an allocation to all eligible NHCs that equals or exceeds 5 percent of compensation, the regulations will have little or no impact.

Example. If the HCEs in a plan that utilizes cross-testing to show nondiscrimination are receiving an allocation of 20 percent of compensation, then the NHCEs must receive an allocation that is one-third of that amount (6.67 percent) or 5 percent, whichever is smaller. In this case, a 5 percent allocation to the NHCEs would meet the gateway contribution. On the other hand, if the HCEs received a contribution of 12 percent of compensation, then the NHCEs need only receive an allocation of 4 percent since that would be one-third of the HCE allocation and 5 percent would exceed that amount.

Cross-Tested Plan Design Basics

In the preceding material, we have looked at only a small portion of the rules and processes for general testing a retirement plan for the purposes of determining what is and what is not discriminatory within the eyes of the IRS. It is critical that the reader understand that it is *not* our intention that reading the preceding material (and even understanding it) will equip you to actually do any of this testing. The rules and regulations are extremely complex and we have only touched on most of the concepts. They are all much more complicated than this treatment allows us to explain, with well over 300 pages of actual regulations attempting to provide more complete guidance. In the designs of retirement plans that are meant to comply with these nondiscrimination rules, the involvement of a competent professional retirement plan consultant is absolutely imperative. This is *not* an area where you can “go it alone.”

There are simple retirement plan designs, often represented by plan documents provided in what is known as a *prototype* document, specifically, a standardized prototype document. This document, as designed by the IRS itself, is extremely limited as to what is allowed to be selected. The resulting plan, if operated in accordance with that document, tends to be more generous to the NHCEs than the law requires. These documents have also been compared to “giving away the store” to the rank-and-file employees. Moreover, noncompliance with the prototype document is likely, unless there is a *competent* retirement plan professional or organization involved.

If your small business client is looking to design a retirement program from which the owners and HCEs will receive significant benefits and the rank-and-file employees will benefit to a much smaller degree, then a plan that utilizes the demographics of the employee group and relies on general testing (or cross-testing) is very often the plan of choice.

Let us look at some design options that are normally utilized in a cross-tested plan.

The Demographics of the Group

The key demographic features that allow a cross-tested plan to best meet an employer's objectives for its retirement plan program is to have older, higher paid owners and younger, lower paid rank-and-file employees. This is a *general* requirement, and the older the owners and the younger the employees, the more likely that a cross-tested plan design will work. By “work,” we mean that we will be able to provide significantly greater benefits to the owners at a reasonable cost for the rank-and-file employees. Generally, the lowest cost for rank-and-file employees in order to pass the general test will be to provide just the amount necessary to meet the gateway contribution tests noted above. In most cases, this minimum will be a 5-percent contribution to the NHCEs, since the HCEs will be receiving a benefit that is at least three times that.

Having demographics does not mean that you cannot have older rank-and-file employees and younger owners. It just doesn't help our overall testing to have such combinations. But the real world of client employee populations often presents such real world situations, and they must be factored into designing the appropriate plan provisions to accomplish the employer's objectives.

Let's look at some basic cross-tested design ideas; remember that in real life, these situations will almost always be much more complicated, and these plans need to be continuously monitored to make sure they will be able to pass the nondiscrimination tests each and every year.

Super Integrated Designs

Many retirement plans that are *not* intended to be cross-tested utilize something that traditionally has been called *integration with Social Security* and is now more appropriately called utilizing permitted disparity. These design-based, safe-harbor plans allow for a slightly higher allocation to those employees who have higher income levels. The concept here is that since Social Security benefits (half of which are paid for by the employer's contributions to Social Security, which is equal to the employee's tax) provide a higher *percentage* benefit to lower income earners, the employer's retirement plan is allowed to offset that inherent inequity by allowing the employer to provide a slightly larger allocation to the higher paid employees in the employer's plan. This process is very tightly controlled by IRS regulations, and the amount of additional allocation to the highly compensated is limited if the plan is going to continue to be a safe-harbor, design-based program.

In a cross-tested design, we take this concept of Social Security integration and significantly enlarge it. An example of a super integrated formula might be an allocation provision under which all the employees get, first, an allocation of 5 percent of their compensation across the board. Note that this 5 percent contribution will meet the gateway test for cross-testing. Then, after this contribution is allocated to all participants (including our highly compensated owners), a second level of allocation is provided of, say, 100 percent of compensation in excess of \$100,000. Let us look at an example of how the math works.

Assume an owner whose compensation is higher than the maximum the law allows to be taken into account for qualified retirement plans. As of the current year, 2007, that limit is \$225,000. Thus, an owner whose compensation exceeds this level will have his or her compensation *capped* at the \$225,000 level. In the first stage of our formula, this HCE receives an allocation of 5 percent of compensation, just like all the other employees. So, 5 percent of \$225,000 would be \$11,250.

The maximum allocation of employer contributions in a defined contribution plan that any plan participant can receive is limited under IRC Section 415) to \$45,000 (effective 2007). (An additional amount, \$5,000 (for 2006 and 2007), can be provided if a plan includes a 401(k) feature and the individual involved is age 50 or older. Such an individual is then eligible for this catch-up provisions provided under IRC Section 414(v).) Applying our second-level allocation formula, we subtract \$100,000 from \$225,000 to get an "excess compensation" amount of \$125,000. Our formula says that we calculate 100 percent of this amount, which would also be equal to \$125,000. Now, since the law provides an overall limit of \$45,000 (as noted above), we cannot actually allocate \$125,000. Instead, we are allowed to allocate only as much as would bring this participant up to the maximum allocation of \$45,000; in this case, an additional \$33,750.

As you can see, the second-level allocation formula is really just meant to maximize those participants whose income exceeds, in this example, \$100,000. The integration level selected can be higher or lower, so long as the resulting allocation for the HCEs involved produces the maximum allocation under the law.

Once we have our allocations calculated for all the participants, we have to actually run our nondiscrimination testing to see if we pass all the required tests. If we do, it is great; if not, we will have to take corrective action to make sure that the plan does pass. (See the following sections.)

Individual Modifications

It is permissible to have different levels of contributions for different participants in the plan. For example, we might have a highly compensated salesperson who makes \$150,000 per year, but is not an owner of the business. It is quite possible that the owners do not want to provide a maximum retirement plan contribution to this individual, even though he is an HCE. We could add a provision to the plan formula that says the following:

Notwithstanding the plan's allocation formula above, Johnny Salesman will be limited to a maximum annual allocation in this plan of 5 percent of his compensation under the plan.

Such a provision would override the general formula, and the salesman would get just the 5 percent allocation provided by the first allocation level of the formula and nothing out of the second level. Since we are discriminating here *against* an HCE, we are allowed to do so. In fact, this will help in the passing of the overall nondiscrimination tests because the EBAR for this highly compensated individual will be significantly lower than what the EBAR would have been if he had received the maximum legal allocation. Thus, in our testing, the average for the HCEs will be lower, and it will be easier for the other HCEs (the owners in this case) to pass the nondiscrimination testing process.

This same type of limitation can be applied if children of the owners are covered under the plan. Under the attribution rules of IRC Section 318, a child of a more than 5 percent owner (one of the definitions of an HCE) is considered an HCE regardless of his or her actual compensation or ownership. Thus, because of familial relationships, a young, lower paid employee who happens to be a child of an HCE will be included in the HCE group for testing and could significantly adversely affect the testing results. To prevent this, we could limit the allocation to that child (via the language of the plan document) to a very small amount, including a zero allocation.

We might have the same situation with a spouse on the payroll who is taking a modest income. By giving that spouse a full allocation, we will generally be hurting the demographic testing of the plan. Therefore, by discriminating against that spouse (who by definition is also an HCE due to family attribution), we enhance our demographics for testing purposes and might end up saving many thousands of dollars that we might otherwise have to distribute to the NHCEs in order to pass the nondiscrimination tests.

Use of Allocation Groups in the Plan Design

Another method of providing larger contributions for our HCEs is to define specific allocation groups within the plan. For example, a physician group is looking for a plan design that will provide a greater share of allocations to the five shareholder physicians under the corporation's profit-sharing plan. Currently, the plan uses a safe-harbor permitted disparity formula and each doctor earns well in excess of \$250,000.

The plan is amended to create two allocation groups, namely, Group A and Group B. Group A consists of shareholders and Group B consists of all other participants (in this case, we have 10 eligible participants in Group B). The plan authorizes the employer to make separate discretionary contributions to each allocation group. When making a contribution, the employer must designate in writing how the contribution is to be divided between the two groups.

A total of \$255,000 is contributed by the corporation for the current plan year. The employer designates \$225,000 of the contribution for Group A (which is $5 \times \$45,000$ so that each doctor receives the maximum legal allocation) and the rest of the contribution for Group B. The \$30,000 contribution for the Group B employees equates to a contribution of 10 percent of their compensation (the total compensation for the 10 participants is \$300,000). The doctors did not have to provide this high a benefit, but that is what they wanted to provide to their employees. When we do the nondiscrimination testing, we find that we pass the tests with this 10 percent allocation to Group B.

Each Participant in His or Her Own Allocation Group

The division of participants in allocation groups can be taken to the logical conclusion, which is to place each and every participant in his or her own allocation group. Then, the employer can carefully determine (with the retirement plan consultant's help and guidance) how much will be allocated to each and every participant. Such a design is absolutely permissible, but it does require significant attention to detail. One particular issue that must be watched is the previously mentioned requirement that the employer must designate in writing how the contribution is to be divided between the multiple groups.

Benefits, Rights, and Features

It is important to note that there are other nondiscrimination rules in addition to the mathematical tests. Though we are not going to discuss them in depth, in addition to contributions or benefits having to be nondiscriminatory, the benefits, rights, and features provided by the plan must be available on a nondiscriminatory basis.² Two additional availability tests must be satisfied, namely, a current availability test and an effective availability test. The details of these tests, which are beyond the scope of this chapter, once again point to the importance of having a competent plan adviser who is aware of these requirements.

We Failed! What Now?

If the contributions or benefits under the plan are discriminatory, or if the availability of benefits, rights, and features is discriminatory, corrective action must be taken (an amendment adopted) within 9½ months after the close of the plan year (for example, October 15, following the end of a calendar plan year).

Corrective Amendment to the Rescue

A corrective amendment may increase contributions or benefits, or add participants, so that the plan can satisfy one of the safe-harbor tests available under the IRC Section 401(a)(4) regulations or so that the contributions or benefits can satisfy the rate group test described above.

A corrective amendment may not reduce accrued benefits to correct discrimination. Thus, it is not allowed to retroactively reduce the benefit even for an HCE so that the tests may be met. Such an amendment would violate the anti-cutback rules under IRC Section 411(d)(6) and is not permitted.

² Treas. Reg. Section 1.401(a)(4)-4.

Amendment Subject to Testing on Its Own

In addition, the additional allocation in the amendment must itself be tested and must pass IRC Section 401(a)(4) on its own unless the plan is being amended so that it would pass one of the safe-harbor tests. If only NHCEs are being credited with additional contributions, then no testing is necessary since it would be impossible for such an amendment to fail the discrimination tests based on the numbers alone.

Amendment Must Have Substance

The amendment must have substance for the affected employees. If you were to provide that additional dollars are added to terminated NHCEs who are not vested, the amendment would be disregarded since no economic benefit would be received by the employee from such an amendment. Note that this is true, even though if that additional contribution had been part of the original allocation, the plan would have passed the nondiscrimination tests and the participant still would not have received the funds because he was zero percent vested. If it is critical that the former employee's benefits be enhanced to pass the tests, then it is possible to include in the amendment a change to the vesting schedule such that the terminated participant is now entitled to a vested benefit of some amount. The IRS will want to make sure that the vested amount is of substance, so vesting the employee in, say, ten dollars probably would not fly. But providing a minimum vesting of, say, 10 percent of the account probably would be substantial enough, but it is a facts and circumstances determination subject to IRS discretion as to how they view it.

Miscellaneous Issues

A number of plans fall outside the usual concerns and testing about nondiscrimination. These include plans that benefit only NHCEs, and plans under which all employees are HCEs.

Plans That Cover Only NHCEs

A plan that benefits only NHCEs is deemed to be nondiscriminatory because all the nondiscrimination tests look at whether we are discriminating *in favor of* HCEs. Thus, no matter how our allocation formula works, if no HCEs are benefiting, it is impossible to fail the rate group test because there are no rate groups to test! In addition, a plan that does not cover HCEs will be deemed to pass the coverage requirements of IRC Section 410(b). This concept of automatic passing of the nondiscrimination tests means that an employer has almost unlimited flexibility when designing a plan allocation formula if no HCEs are covered by the plan.

The law does not say that we cannot discriminate *in favor of* some NHCEs over other NHCEs. It likewise doesn't say we can't discriminate *against* HCEs. The specific prohibition is that we cannot impermissibly discriminate *in favor of* HCEs.

Plans That Cover Only HCEs

If an employer's entire work force consists of only HCEs, there is no one against whom discrimination could occur since there are no NHCEs. Since there is no possibility of discrimination against NHCEs, the plan would be deemed nondiscriminatory even though all of the participants are HCEs. Likewise, such a plan is deemed to pass the coverage requirements.

The same result would hold if the employer does have NHCEs, but all of the NHCEs are *otherwise excludable* such as they do not meet the minimum age and service requirements, or they are all union employees subject to collective bargaining.

Conclusion

The design of cross-tested plans is both an art and a science. The enormous complexity of the IRS regulations in this area provides both opportunities and pitfalls for the practitioner. The need to have competent assistance on an initial and ongoing basis cannot be overemphasized. Intelligent practitioners will recognize that they cannot afford to go it alone in this area. The risk of mistakes is high and the penalty can be catastrophic—both for the client and the practitioner.

The material presented in this chapter is far from a complete examination of this area and will *not* equip practitioners to design and administer these plans on their own. It is a wise individual who knows his or her limitations and calls in the artillery when appropriate.

Chapter 10

Defined Benefit Plan Design

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If we were to look at the number of defined benefit plans in existence today versus 20 years ago, it would not be surprising to hear us say that defined benefit plans are dead. Specifically, there are 80-percent fewer defined benefit plans in place today than there were 20 years ago. It would not be hard for one to conclude that there is obviously something terribly wrong with these animals and anyone who is smart will stay away from them. Indeed, many accountants feel that way.

Why the decline? There are a number of reasons, primarily the following:

1. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)
2. The Tax Reform Act of 1986 (TRA 86)
3. The stock market run-up of the 1980s and 1990s

The tax law changes because they decreased the maximum benefits payable and increased complexity, and the stock market run-up because, combined with the reduced benefit limits, many plans became fully funded or overfunded.

But are defined benefit plans *really* dead? Or better yet, are they *still* dead? In a word, no.

Introduction

Over the past several years, there has been a revival of defined benefit plans, particularly in the small employer arena, and even more so with the advent of cash balance plans (to be discussed in more detail later in this chapter). There are several reasons for this resurgence, including:

1. The repeal of Internal Revenue Code (IRC or the Code) Section 415(e) by the Small Business Jobs Protection Act of 1996 (SBJPA)

2. The aging of the Baby-Boom generation, combined with this group's realization that it has not saved enough for retirement
3. The (perceived or not) ultimate demise of the Social Security system
4. More recently, the increase in benefit limits brought about by the Economic Growth and Tax Reform and Reconciliation Act of 2001 (EGTRRA)
5. Most recently, the relaxation of the IRC Section 404(a)(7) deduction limits, where an employer maintains both a defined benefit plan and a defined contribution plan, by the Pension Protection Act of 2006 (PPA).

So what is a defined benefit plan? According to the Internal Revenue Code, a defined benefit plan is “. . . any plan which is not a defined contribution plan.”¹ To get a better answer, one must then look to the definition of defined contribution plan, which is found one paragraph earlier in IRC Section 414. There, we see that a defined contribution plan is a plan in which the benefit is based solely on amounts contributed to an individual's account and the actual earnings on such account.² In a nutshell, in a defined benefit plan, the investment risk is borne by the plan sponsor, whereas, in a defined contribution plan, the risk is borne by the participant.

Defined benefit plans are not, of course, for everyone. As we have seen in previous chapters, up to \$45,000 (and even more with catch-up contributions) can be contributed annually to a defined contribution on an individual's behalf. In a majority of cases, this is ample retirement savings. However, for those with significant income, and certain other cases we will discuss, the defined benefit plan makes sense.

Defined benefit plans are certainly much more complex in nature than defined contribution plans. For starters, an additional professional, an *enrolled actuary*, enters the picture. This individual is charged with determining the proper funding of the plan, as well as the proper payouts to terminating employees.

Also, defined benefit plans are subject to minimum funding standards, standards which, if not met, can result in the imposition of excise taxes.³ That is, unlike a profit-sharing plan, for example, required contributions *must* be made. The secret is to manage required contributions and to use available mechanisms to reduce or eliminate them when necessary.

Finally, certain defined benefit plans must purchase insurance coverage guaranteeing some or all benefits from a federal agency known as the Pension Benefit Guaranty Corporation (PBGC).

With this, we begin a discussion of some of the rules applicable to defined benefit plans. The idea here is not to make the reader an expert; that would require an entire book larger than this one. The idea is to provide a general understanding of the utility of defined benefit plans such that the reader will grasp when such a plan may be appropriate. Used properly, and in the right circumstances, a defined benefit plan can be a very effective and useful tax and financial planning tool.

Benefit Limits

Under IRC Section 415(b), the annual benefit that can be provided by a defined benefit plan cannot exceed the lesser of (1) \$160,000 (the dollar limit), or (2) 100 percent of the participant's average compensation for his or her high three years (the percentage of pay limit). In order for an individual to receive the full dollar limit,

¹ IRC Section 414(j).

² IRC Section 414(i).

³ IRC Section 4971.

he or she must have at least 10 years of participation in the plan. In order for an individual to receive the full percentage of pay limit, he or she must have at least 10 years of service with the employer.⁴

The dollar limit must be actuarially reduced where benefit begins *prior* to age 62.⁵ The details of these calculations are beyond the scope of this chapter, but an important factor is that the benefit limit is the lesser of that provided when reduction is performed using (1) the interest rate and mortality table set forth in the plan, and (2) the applicable mortality table⁶ and 5 percent. If the maximum benefits are desired, the latter factors are, therefore, the same as the plan factors.

If benefit payments are to begin anywhere from age 62-65, the dollar limit is \$160,000. Note that the dollar limit is adjusted for inflation.⁷ Beginning with plan years ending in 2007, the limit is \$180,000.

Using 5 percent and the applicable mortality table, annual dollar limits for 2007 are as follows:

Retirement Age	Benefit Limit
50	81,440
51	86,646
52	92,248
53	98,280
54	104,783
55	111,803
56	119,387
57	127,587
58	136,457
59	146,059
60	156,465
61	167,753
62	180,000

Similarly, if benefit payments are to begin after age 65, the benefit limit is actuarially increased⁸. The limit is the lesser of that provided when reduction is performed using (1) the interest rate and mortality table set forth in the plan, and (2) the applicable mortality table and 5 percent. Using the latter factors, annual dollar limits for 2007 are as follows:

⁴ IRC Section 415(b)(5).

⁵ IRC Section 415(b)(2)(C). The manner in which the reduction is made is set forth in Regulation Section 1.415(b)-1(d)(1).

⁶ Currently set forth in Revenue Ruling 2001-62.

⁷ IRC Section 415(d).

⁸ IRC Section 415(b)(1)(D).

Retirement Age	Benefit Limit
65	180,000
66	193,754
67	208,724
68	225,061
69	242,965
70	262,639
71	284,339
72	308,306
73	334,774
74	364,084
75	396,611
76	432,765
77	473,015
78	517,676
79	567,252
80	622,304

Average Compensation

Again, the percentage of pay limit is 100 percent of the participant's average compensation for his or her high three years. A participant's high three years are the period of consecutive years (not more than three) during which the participant had the highest aggregate compensation from the employer (including years before the effective date of the plan).⁹

Example. Maria is the sole owner and sole employee of ABC Corporation. Before pension and salary, ABC has consistently earned \$75,000 to \$100,000. ABC has been in existence for five years, and, in each year, Maria has received a salary of \$50,000. ABC is considering the adoption of a defined benefit plan on Maria's behalf. In order to fund the plan, ABC will have to reduce Maria's salary. Since Maria has three consecutive years at \$50,000, however, her average compensation for purposes of the percentage of pay limit would still be \$50,000.

IRC Section 401(a)(17) provides for a limitation on the amount of compensation that may be considered for certain qualified plan purposes. This amount is \$225,000 for years beginning in 2007. For years beginning prior to July 1, 2007, this limit did not apply for purposes of the 100% of compensation limit of IRC Section 415(b)(1)(B).

⁹ IRC Section 415(b)(3), as amended by the Pension Protection Act of 2006.

On April 4, 2007, a highly controversial set of regulations was issued under IRC Section 415. Effective for years beginning on or after July 1, 2007, Regulation Sections 1.415(c)-2(f) and 1.415(b)-1(a)(5)(i) now provide that the limitations of IRC Section 401(a)(17) do apply for purposes of the 100% compensation limit.

Specifically, the regulations provide that the compensation used for a year in determining the benefit limit may not reflect compensation that is in excess of the IRC Section 401(a)(17) limit in effect for the year. Grandfather rules apply for benefits earned as of the effective date of the new regulations.

Example. Participant N has been a participant in Plan B since January 1, 2002. N has worked for the sponsor of Plan B for more than 10 years. N's compensation for 2008, 2009, and 2010 is \$300,000 for each year. N's average compensation for the period of N's high-3 years of service (determined before the application of IRC Section 401(a)(17)) is therefore \$300,000. For all years before 2008, Participant N's compensation was less than the then-applicable IRC Section 401(a)(17) limit. On January 1, 2011, N commences receiving benefits from Plan B at the age of 72, when the age-adjusted IRC Section 415(b)(1)(A) dollar limit for benefits is \$308,306. Since Participant N has 9 years of participation in Plan B, N's IRC Section 415(b)(1)(A) dollar limit is \$277,475 (9/10 times \$308,306).

As indicated above, Plan B is not permitted to provide for a definition of compensation that includes compensation for a year that is in excess of the limitation under IRC Section 401(a)(17) that applies to that year. Accordingly, the limitation under IRC Section 415(b)(1)(B) based on N's average compensation for the period of N's high three years of service must not reflect compensation for a year that is in excess of the limitation under IRC Section 401(a)(17) that applies to that year. Thus, if the limitation under IRC Section 401(a)(17) for years beginning in 2008, 2009, and 2010 is \$230,000, \$235,000, and \$240,000, respectively, then the 100% of Compensation limit under IRC Section 415(b)(1)(B) based on N's average compensation for the period of N's high three years of service is \$235,000.

Since the limitation under IRC Section 415(b)(1) is the lesser of the dollar limit or the percentage of compensation limit, Participant N's maximum annual benefit is \$235,000.

All Defined Benefit Plans of the Employer

When determining the above benefit limits, all defined benefit plans of an employer (whether or not terminated) must be combined. For this purpose the employer includes any affiliated employer.¹⁰

Funding

The limits discussed in the preceding section are benefit limits. As accountants, we, of course, want to know the funding or deduction limit. That is, how much can the employer put in the plan? Basically, it is the amount needed to fund the benefits payable under the plan, with the benefits being subject to the limits previously discussed.

Under the Pension Protection Act of 2006, the funding rules are the subject of considerable modification. Effective with plan years beginning after 2007, the funding rules as we've known them since the passage of ERISA have been replaced with a new set of rules.¹¹ Since the current rules are effective through 2007,¹² this chapter discusses both sets of rules.

¹⁰ IRC Sections 414(b), (c), (m), and (o).

¹¹ IRC Section 430.

¹² And in the case of fiscal plan years through plan years ending as late as November, 2008.

Plan Years Beginning Prior to January 1, 2008

Actuarial Assumptions

As previously indicated, the required funding is determined by an enrolled actuary. In determining the amount of funding the actuary must use certain assumptions, known as *actuarial assumptions*. Assumptions must be reasonable and must reflect the actuary's best estimate of anticipated experience under the plan.¹³ The following are some of the factors or assumptions that the actuary may take into account:

- Investment earnings of the fund prior to retirement (preretirement interest)
- Postretirement interest
- Pre- and postretirement mortality
- Employee turnover
- Salary increases
- Expenses
- Postretirement cost-of-living adjustments (COLAs)

In the small plan context, often the only assumptions considered are pre- and postretirement interest and postretirement mortality. For simplicity, these are the only assumptions that will be considered in the remainder of our discussion.

Funding Methods

In determining the amount of funding, in addition to funding assumptions, the actuary must also choose a funding method.¹⁴ There are basically seven funding methods, as follows:

1. Unit credit (also called accrued benefit)
2. Individual spread gain (ISG, also called individual aggregate)
3. Aggregate
4. Entry age normal
5. Individual level premium
6. Attained age normal
7. Frozen initial liability

The author's experience has been that in the small plan market, the first two of these methods, the unit credit and individual spread gain (ISG), are used most often. They are also the easiest to explain and our discussion will be limited to these methods.

Funding Standard Account

Under any funding method, the annual contribution requirement is the net of the charges (costs) and credits to the funding standard account (FSA). The most common charges to the FSA are:

1. Normal cost
2. Amortization charges
3. Interest on items 1 and 2

¹³ IRC Section 412(c)(3).

¹⁴ Revenue Procedure 2000-40.

The most common credits to the FSA are:

1. Prior-year overpayment (credit balance)
2. Deposits to the plan
3. Amortization credits
4. Interest on items 1 to 3

Unit Credit Funding

Ordinarily, the *normal cost* is the most significant charge to the FSA. Under the unit credit funding method, the normal cost is the present value of the increase in the accrued benefit during the year. The *accrued benefit* is the portion of the participant's retirement benefit that has been earned at any point in time.

Example. ABC adopts a defined benefit plan for Maria. Under the plan, Maria will receive an annual retirement benefit of \$5,000 for each year that she is a participant in the plan. Maria is currently age 55, and normal retirement under the plan is age 65. Presuming she remains employed and the plan is not amended, Maria's accrued benefit will be \$5,000 at age 56, \$10,000 at age 57, \$15,000 at age 58, etc., until it reaches \$50,000 at age 65. In year one, therefore, the normal cost under the unit credit method of funding would be the present value, at age 56, of a \$5,000 annual payment, for life, beginning at age 65.

In order to determine the present value of the increase in the accrued benefit, we need to look at our actuarial assumptions. Previously, we indicated that we would constrain ourselves to pre- and postretirement interest and postretirement mortality (how long will payments continue after retirement). Preretirement interest represents the assumed earnings on plan assets prior to retirement. The combination of postretirement interest and postretirement mortality lead to the annuity purchase rate. The annuity purchase rate is the cost of an annuity, based on the age and gender of the contract owner and other factors; it is essentially the amount needed today to pay \$1 annually for the life of the participant.

Postretirement interest requires the selection of an interest rate (for instance, 5 percent). Basically, this means the interest that will be earned during the period of payout. Postretirement mortality requires the selection of a mortality table. There are a number of mortality tables in use today, but we will use the 1994 Group Annuity Reserving table projected to 2002.¹⁵ At age 65, using a postretirement interest rate of 5 percent, this results in an annuity purchase rate of 12.252.

Example. Reconsider Maria and her plan at ABC. What's the normal cost in year one? Again, at the end of year one, Maria has earned the right to receive \$5,000 per year, for the rest of her life, beginning when she turns age 65. With an annuity purchase rate of 12.252, this means the plan will need to have \$61,260 when Maria turns 65. But this is nine years away, so the normal cost is the present value of \$61,260 due in nine years, discounted using the preretirement interest rate. Presuming the preretirement rate is also 5 percent, the normal cost at the end of year one is \$39,489. That is, \$39,489 deposited at the end of year one, earning 5 percent each year, will grow to \$61,260 at the end of year 10. This amount will then be available to provide Maria with \$5,000 per year for life.

Presuming she remains employed and the plan is not amended, Maria's accrued benefit will grow by another \$5,000 in year two. Accordingly, at the end of year two, she will have earned the right to receive \$10,000 annually, for the rest of her life, beginning when she turns age 65. The normal cost in year two is the present

¹⁵ The table set forth in Revenue Ruling 2001-62.

value of the \$5,000 increase in the accrued benefit. Again, the value at age 65 is \$61,260 (the annuity purchase rate of 12.252 times the \$5,000 increase in the accrued benefit). But the present value will be greater than it was in year one, since we are a year closer to retirement. Again, using a discount rate of 5 percent, but discounted this time for eight years, our present value, (our normal cost) is \$41,463.

Actuarial Gains and Losses

What happens if (when) the plan does not earn 5 percent on year one's deposit? That is, it's a pretty good bet that the \$39,489 deposited at the end of year one will not be worth exactly 5 percent more at the end of year two. That is, with a preretirement interest rate of 5 percent, we have assumed that the deposit will grow by 5 percent each year such that at the end of year two, prior to year two's deposit, there will be $\$39,489 \times 1.05$ or \$41,463 in the plan. What if there's more or less?

The difference between the expected return and the actual return is referred to as an *actuarial gain* or *actuarial loss*. Presume that at the end of year two, there is only \$40,000 in the plan. There is an actuarial loss of \$1,463. What we do with this loss depends on the funding method we are using.

One of the characteristics of the unit credit funding method is that it is an immediate gain method. This means that each year's actuarial gain or loss is immediately recognized, and amortized over a certain period, generally five years.¹⁶ Other funding methods (including ISG) are what are called spread gain methods. This means that gains and losses are spread over the remaining working lives of the participants in the plan.

Example. At the end of year two, the ABC plan has assets of \$40,000. That is, the \$39,489 deposited at the end of year one did not grow by the assumed 5 percent to \$41,463. There is, therefore, an actuarial loss of \$1,463. This loss must be amortized over a five-year period at the preretirement interest rate used for funding. This is effectively the same as paying off a loan of \$1,463 over a five-year period. Accordingly, in addition to the normal cost for year two, an additional \$338 (an amortization charge) must be deposited.

What if there is \$42,000 instead of \$40,000? This means there is an actuarial gain of \$537 (\$42,000 less the expected \$41,463). This results in an amortization credit of \$124 for each of the next five years. This amount serves to reduce the otherwise required contribution for year two.

As the above demonstrates, unit credit funding closely tracks benefit accruals. That is, benefits are being funded as they are earned. If funding assumptions are similar to actuarial equivalence factors, payout amounts will coincide with accumulated funding. (See the following discussion of payment of benefits.) This makes unit credit a convenient funding method to use in a setting in which individual costs are being closely tracked and allocated to each individual, as is often the case in a professional setting.

Individual Spread Gain

Let's now look at how funding differs using ISG to fund the plan. Under this method, the full benefit expected at retirement is projected, and the normal cost is the level annual amount needed to accumulate the funds required to provide this benefit. For this reason, ISG is often referred to as a level funding method.

Example. Assume that instead of using unit credit funding the ABC plan uses the ISG method. Recall that the plan provides for a benefit of \$5,000 for each year of participation in the plan. Maria enters the plan at age 55, and the plan's normal retirement age is 65. She is, therefore, projected to have 10 years of participation in the plan, such that her projected benefit is \$50,000. Again, using an annuity purchase rate of

¹⁶ IRC Sections 412(b)(2)(B)(iv) and 412(b)(3)(B)(ii).

12.252, this means that the plan will need \$612,600 at the end of 10 years to provide this projected benefit. The normal cost is then the level amount needed to reach this amount at the end of 10 years.

How is this amount determined? First, we compute the present value. The present value is \$612,600 discounted back nine years (as we are performing this valuation at the end of year one). Continuing to use 5 percent, our present value is \$394,887. Again, this can be equated to a loan of this amount, with a repayment period of 10 years. The result is an annual payment, or normal cost, of \$48,705.

As indicated above, the difference between the actual and projected investment gain or loss is referred to as an actuarial gain or loss. Under ISG, such gain or loss is spread over the remaining working lives of the plan participants. The manner in which this is done is set forth in the following example:

Example. At the end of year two, the ABC plan has assets of \$50,000. That is, the \$48,705 deposited at the end of year one did not grow by the assumed 5 percent to \$51,140. There is, therefore, an actuarial loss of \$1,140. Since the plan is using ISG for funding, there is no amortization charge. Instead, the loss is effectively folded into the normal cost going forward.

Presuming she remains employed and the plan is not amended, Maria's projected benefit remains at \$50,000 in year two. Again, we begin by computing the present value of the projected benefit. The present value is \$612,600 discounted back eight years now, or \$414,632. But we now have assets. These assets are subtracted from the present value of the projected benefit to arrive at the "present value of future normal costs."

Accordingly, the \$50,000 of assets is subtracted from the \$414,632 present value to arrive at a present value of future normal cost totaling \$364,632. The normal cost is then equated to the payments on a loan of this amount over a period of nine years. The result is an annual payment, or normal cost, of \$48,857.

Note that the normal cost in year two is slightly higher than that in year one. The reason is the spreading of the actuarial loss. If the plan instead earned the assumed 5 percent each year, the normal cost, and annual funding, of the plan would remain constant over the 10 years to retirement (presuming that the projected benefit did not change).

Contrast this to the funding pattern under the unit credit method. Recall from above that the normal cost in year two was 5 percent higher than that in year one. This was due to the fact that the normal cost under such method is the present value of the increase in the accrued benefit. All things being equal, the present value of something in year two will be higher than the present value of the same amount in year one by a factor of the interest rate being used. If the normal cost is projected to remain at \$48,705 where all assumptions were met under the ISG method, the normal cost (and annual funding if all assumptions are met) under the unit credit method would look like this:

Year	Normal Cost
1	\$39,489
2	41,463
3	43,536
4	45,713
5	47,999

(continued)

Year	Normal Cost
6	50,399
7	52,919
8	55,565
9	58,343
10	61,260

Note that the same number of dollars will be accumulated. ISG simply provides for funding on a level basis where the unit credit method provides for steadily increasing funding. There is no right way or wrong way. The choice of funding method is based on a number of facts and circumstances, some of which will be addressed later in this chapter.

Let's add some zeros to our numbers. That is, we have been working with a relatively modest plan for a very small company. We have also been working with a single participant and a flat dollar (as opposed to percentage of pay) benefit formula. Let's add an employee, and blow the numbers up a bit.

Recall from above that the maximum benefit that Maria can receive is the lesser of the dollar limit or the percentage of pay limit. Presuming retirement is age 62 or later and the year is 2007, the former is \$180,000 (reduced if there are less than 10 years of plan participation when payments commence) and the latter is 100 percent of average compensation for the participant's high three consecutive years (reduced if there have been fewer than ten years of service with the employer when payments commence).

Example. Let's assume that Maria's compensation has consistently been \$225,000 per year instead of \$50,000. Also, assume there is another employee of ABC, John, who is 35 years old and has consistently earned \$35,000 annually. ABC wishes to adopt a plan to maximize Maria's benefit. Staying with a retirement age of 65, Maria will have 10 years of participation in the plan, such that her dollar limit will be \$180,000. Her percentage of pay limit will be \$225,000. The maximum benefit is the lesser of the two, or \$180,000.

\$180,000 represents 80 percent of Maria's pay. Since Maria will be in the plan for 10 years, we will set the plan's benefit formula to provide for a retirement benefit of 8 percent of compensation for each year of participation in the plan, up to a maximum of 10 years.

We first look at unit credit funding. At the end of year one, Maria has an accrued benefit of \$18,000 (\$225,000 times 8 percent), and John has an accrued benefit of \$2,800 (\$35,000 times 8 percent). Each of these amounts is payable annually for the participant's life beginning at age 65. First-year normal costs for the two participants are as follows:

	Maria	John
Increase in accrued benefit	\$18,000	\$2,800
Annuity purchase rate at age 65	12.252	12.252
Future value of increase	220,536	34,306
Years to retirement (end of year)	9	29
Discount factor at 5%	.64461	.24295
Normal cost	142,160	8,335

In order to determine the normal cost using ISG, we must first determine the projected benefit for each participant. We then determine the present value of this projected benefit and our normal cost is the level amount needed to pay this loan.

Example. Maria's projected benefit is \$180,000 (\$225,000 times 8 percent times 10 years) and John's is \$28,000 (\$35,000 times 8 percent times 10 years). Using ISG, normal costs are as follows:

	Maria	John
Projected benefit	\$180,000	\$28,000
Annuity purchase rate at age 65	12.252	12.252
Future value of projected benefit	2,205,360	343,056
Years to retirement (end of year)	9	29
Discount factor at 5%	.64461	.24295
Present value of future normal cost	1,421,597	83,344
Normal cost	175,336	5,163

Compared to unit credit funding, you will notice that Maria's normal cost increases while John's decreases. This is due to the funding period versus the accrual period, the latter being the period over which the benefit is earned, or accrued. Maria is projected to be a participant in the plan for 10 years, from age 55 to age 65, the same number of years during which she is earning her benefit. John, on the other hand, is projected to be a participant in the plan for 30 years. His benefit will be earned, however, over the first 10 years (although in later years his benefit will increase if his pay continues to increase).

When using the unit credit method, funding is done over the period in which the benefit is earned. Under ISG conversely, funding is done over the participant's entire working life. So, all things being equal, and ignoring actuarial gains and losses as well as salary increases, the normal cost (and contribution to the plan) for John would be \$5,163 each year for 30 years, using ISG. With the same assumptions, using unit credit funding, the annual normal costs would be as follows:

John's Age End of Year	Normal Cost
36	\$ 8,335
37	8,752
38	9,190
39	9,650
40	10,133
41	10,640
42	11,172
43	11,731
44	12,318
45	12,934

Play with a spreadsheet a bit, and you will see that depositing the above numbers for 10 years, and then nothing for the next 20 years, will grow to the same \$343,056 as \$5,163 for 30 years, assuming a 5 percent annual rate of return in each case. Any slight difference will be due to rounding.

Recall that under the unit credit funding method, the difference between our projected investment return and our actual investment return is an actuarial gain or loss that is amortized over a five-year period. We also said that under ISG, that such gain or loss is spread over the remaining working lives of the plan participants. In a one participant plan this is easy; it is the life of the single participant. But how is this done if there is more than one participant?

Allocating Assets in Individual Spread Gain

Under ISG, the assets are actually allocated among the participants each year. Note that this allocation is for funding only and has nothing to do with account balances or anything else. The allocation of the assets is proportionate based on each participant's allocation basis. A participant's initial allocation basis is his or her initial normal cost. Thereafter, it is the assets allocated to the participant for the prior year, plus the individual's normal cost for the prior year.

Example. Using ISG, the normal cost in year one for the ABC plan was \$180,499 (\$175,336 for Maria and \$5,163 for John). If the plan earned exactly 5 percent, there would be assets of \$189,524 at the end of year two, or \$184,103 for Maria and \$5,421 for John. These amounts become their allocation basis for purposes of allocating the actual assets at the end of year two.

Assume assets at that time are actually \$185,000. This amount is allocated proportionally to Maria and John based on their allocation basis, such that \$179,709 is allocated to Maria and \$5,291 is allocated to John. Assuming no change in wages or benefits, normal costs for year two are as follows:

	Maria	John
Projected benefit	\$180,000	\$28,000
Annuity purchase rate at age 65	12.252	12.252
Future value of projected benefit	2,205,360	343,056
Years to retirement (end of year)	8	28
Discount factor at 5%	.67684	.25509
Present value of projected benefit	1,492,676	87,510
Allocated assets	179,709	5,291
Present value of future NC	1,312,967	82,219
Normal cost	175,925	5,172

Note that future COLAs cannot be assumed when funding for a participant at the dollar limit. Recall from above that the dollar limit has increased from \$160,000 in 2002 to \$180,000 in 2007. The annual increase for the following year is announced by the IRS via Information Releases in ample time for determining funding for the current year. Nevertheless, when funding a calendar 2007 plan, the largest benefit that the

actuary could presume for funding purposes would be \$180,000¹⁷, notwithstanding that the actuary knows that the benefit will be higher.¹⁸ However, if the plan year ended on the following January 31, for example, it would be appropriate to consider the higher limit.¹⁹

Plan Years Beginning After December 31, 2007

The Pension Protection Act of 2006 replaces the above funding requirements for single-employer defined benefit plans for plan years beginning after 2007 with a new set of rules for determining minimum required contributions. In order for you to understand the rules (or at least somewhat comprehend them), you must first learn some related terms:

Funding Target. A plan's funding target for a plan year is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year.²⁰

Target Normal Cost. A plan's target normal cost is the present value of all benefits expected to accrue or be earned under the plan during the current plan year. For this purpose, an increase in any benefit attributable to services performed in a preceding year by reason of a compensation increase during the current year is treated as having accrued during the current year.²¹

Shortfall Amortization Charge. The sum of the amounts required to amortize any shortfall amortization bases for the plan year and the six preceding plan years.²²

Shortfall Amortization Base. Required to be established for a plan year if the plan has a funding shortfall for the plan year. A shortfall amortization base may be positive or negative (an offsetting amortization base is established for gains).²³

Funding Shortfall. A plan has a Funding Shortfall if the plan's funding target for the year exceeds the value of the plan's assets.²⁴

Required Contribution

Pursuant to IRC Section 430(a), the minimum required contribution for a plan year, based on the value of plan assets compared to the funding target, is as follows:

1. If the value of plan assets is less than the funding target, then the required contribution is the sum of: (1) target normal cost; (2) any shortfall amortization charge; and (3) any waiver amortization charge; and
2. If the value of plan assets equals or exceeds the funding target, then the required contribution is the target normal cost, reduced (but not below zero) by the excess of (1) the value of plan assets, over (2) the funding target.

The funding requirements under IRC Section 430 are very similar to the unit credit method discussed in the preceding section. The target normal cost²⁵ is basically the same as the normal cost under unit credit funding.

¹⁷ Adjusted for before age 62 or after age 65 retirement.

¹⁸ Treasury Regulations Section 1.412(c)(3)-1(d)(1)(i) and Revenue Ruling 81-195.

¹⁹ Revenue Ruling 81-215.

²⁰ IRC Section 430(d)(1).

²¹ IRC Section 430(b).

²² IRC Section 430(c)(1).

²³ IRC Section 430(c)(3).

²⁴ IRC Section 430(c)(4).

²⁵ IRC Section 430(b).

Additionally, actuarial gains and losses are immediately recognized as under unit credit funding, though the amortization period is 7 years instead of 5 years.

Note that for the sake of simplicity many complex issues have been ignored.²⁶ For example, the law provides for extensive rules with respect to funding waivers as well as plans referred to as “at risk” plans. Additionally, the adjustment of assets for use of pre PPA credit balances (referred to as “funding standard carryover balances”) and new credit balances (referred to as “prefunding balances”) has been ignored. Our goal here is not to make the CPA a funding expert, but rather to give him or her a general understanding of the basic concepts of these rules.

Actuarial Assumptions

Under pre PPA law the actuary was given wide latitude in determining the actuarial assumptions to be used for funding purposes. This changes with PPA.

Interest Rates

PPA specifies the interest rates that must be used in determining a plan's target normal cost and funding target. Present value is determined using three interest rates (“segment” rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable thereafter. Each segment rate is a single interest rate determined by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account bonds maturing during the particular segment. PPA directs the Secretary of the Treasury to publish monthly each of the segment rates for the month.

Mortality Tables

Under PPA the Secretary of the Treasury is directed to prescribe mortality tables to be used in determining present value or making any computation under the post 2007 funding rules. The Secretary is required (at least every 10 years) to revise any table in effect to reflect the actual experience of pension plans and projected trends in such experience.

Timing of Contributions

As under pre PPA law, the due date for the payment of a minimum required contribution for a plan year is 8½ months after the end of the plan year. Any payment made on a date other than the valuation date (normally the first day of the plan year) for the plan year must be adjusted for interest. Additionally, quarterly contributions must be made during a plan year if the plan had a funding shortfall for the preceding plan year.

Payment of Benefits

Payment of benefits for a defined benefit plan are subject to a number of rules related to a minimum and maximum lump sum, an applicable interest rate, as well as early termination. Following are the stipulations for each.

Minimum Lump Sums

Most small plan benefits are paid in the form of a lump sum. That is, most employees do not actually end up receiving an annuity for life. Instead, they elect to receive the present value of their benefit in the form of a

²⁶ IRC Section 430 is 15 pages long.

lump sum. The amount of the lump sum is the actuarial equivalent of the life annuity. In this section, we will discuss how this amount is determined.

Example. Two years after commencing participation in the ABC plan, John terminated his employment with ABC at age 37. At the time, John's accrued benefit was \$5,600 (two years at \$2,800). This means that beginning in 28 years (when he reaches age 65), John has the right to receive \$5,600 annually for life. If the employer is a large public company, with a human resources department that tracks terminated employees, this may make sense. For ABC, it is more feasible just to pay John off and make him go away. Of course, that is probably John's preference too.

Actuarial equivalence is really a fancy way of saying present value. It is the single-sum current value of a stream of payments otherwise payable now or in the future. Just as in funding, in order to determine actuarial equivalence for payouts, we need to use actuarial assumptions. But here, the actuary's discretion goes away. That is, the assumptions used must be stated in the plan,²⁷ and the payout amount must be the greater of (1) that determined using the assumptions set forth in the plan, and (2) that using the applicable interest rate and the applicable mortality table.²⁸ The PPA made significant changes, to the rules,²⁹ which we'll cover in the following section.

Applicable Interest Rate

Pursuant to IRC Section 417(e)(3)(A)(ii)(II), for distributions in plan years beginning before 2008, the *applicable interest rate* is the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. If we actually used the month before the date of distribution, we would constantly be revising our numbers. That is, the time between notification to the employee and actual payout often takes a number of months. If the employee is notified that he or she has a benefit coming, you must tell him or her the amount of the lump sum. Actual distribution, however, will occur some number of months in the future. If we were forced to use the rate for the month before distribution, the actual distribution would be some amount other than what the employee was previously told. This is due to the fact that the interest rate, and, therefore, the present value of the future annuity stream, will be different.

To alleviate this problem, the IRS published regulations under IRC Section 417(e). In these regulations, the IRS allows us to choose (*in the plan document*) a stability period and a look-back month. The *stability period*, the period during which the applicable interest rate remains unchanged for purposes of payout calculations, can be from one to 12 months. The *look-back month*, the period prior to the start of the stability period from which the rate is chosen, can be anywhere from zero to five months.

Example. The ABC plan provides for a stability period of 12 months (the calendar year). For a given calendar year, this means that the rate stays the same for the entire year. Additionally, the plan states that the look-back month is the second month preceding the start of the stability period. This means that the rate for a given calendar year will be the rate for November of the preceding year. Accordingly, if a participant receives notice in May that his or her payout will be a certain amount when paid in July, this amount will be the same in July; it will *not* change due to use of the July rate versus the May rate.

²⁷ IRC Section 401(a)(25).

²⁸ IRC Section 417(e)(3).

²⁹ IRC Section 417(e)(3).

The IRS publishes the applicable interest rate each month on their website (<http://www.irs.gov/>). The rate for November 2006, for example, was 4.69 percent. Accordingly, for all of 2007, the ABC plan would use 4.69 percent as the applicable interest rate when determining payouts. As previously mentioned, however, when making payouts, the employee must actually receive the greater of (1) the value using the applicable interest rate and applicable mortality table, the IRC Section 417(e) minimum; or (2) the value using the interest rate and mortality table set forth in the plan.

Example. Recall from above that John terminated employment after two years in the ABC plan with an accrued benefit of \$5,600. John was age 37 at the time of his termination, 28 years from the plan's retirement age. For actuarial equivalence purposes, the plan's interest rate is 5 percent and its mortality table is the applicable mortality table. Again, these factors must be specified in the plan. The annual percentage rate at 65 using these factors is 12.252. Presuming the payout is taking place in 2007, the applicable interest rate is 4.69 percent. At age 65, using this rate and the applicable mortality table, the APR is 12.569. John's payout amount is \$19,505, determined as follows:

	Plan Rates	417(e) Minimum
Accrued benefit	\$ 5,600	\$ 5,600
APR age 65	12.252	12.569
Value at age 65	68,611	70,386
Years to age 65	28	28
Interest rate	5%	4.69%
Discount factor	.25509	.27711
Present value	17,502	19,505

For distributions in plan years beginning after 2007, PPA replaces the 30-year Treasury rate, on a phased in basis, with rates similar to the segment rates discussed above under funding. Additionally, the IRS prescribed mortality table used for funding is also required to be used. For distributions in 2008 through 2011, minimum lump-sum values are determined as the weighted average of two values: (1) the value of the lump sum determined using the factors under pre-PPA law and (2) the value of the lump sum determined using the factors prescribed by PPA.

For distributions in 2008, the weighting factor is 80 percent for the lump-sum value determined using Pre-PPA factors and 20 percent for the lump-sum determined using the factors prescribed by PPA. For distributions in 2009, the weighting factor is 60 percent for the lump-sum value determined using Pre-PPA factors and 40 percent for the lump-sum determined using the factors prescribed by PPA. For distributions in 2010, the weighting factor is 40 percent for the lump-sum value determined using Pre-PPA factors and 60 percent for the lump-sum determined using the factors prescribed by PPA. For distributions in 2011, the weighting factor is 20 percent for the lump-sum value determined using Pre-PPA factors and 80 percent for the lump-sum determined using the factors prescribed by PPA. After 2011 the full amount is determined using the factors prescribed by PPA.

Maximum Lump Sums

It is apparent from the above and mathematically obvious, that the lower the interest rate, the greater the lump-sum payment. A smart accountant might look at this and determine that, in a one-participant, owner-

only plan, if the goal is to shelter as much as possible, it behooves us to have the plan rates extremely low. Before finding that one cannot be this aggressive, look at the following example of what is being said here.

Example. Assume once again that Maria is the only participant in the ABC plan. Also, assume that her annual earnings were \$225,000 for a number of years prior to the plan's inception, high enough that her benefit limit is the dollar limit, which is assumed to be \$180,000. The plan's actuarial equivalence factors are 1 percent interest and the applicable mortality table. At age 65, Maria's number would look like this (the last two columns are explained in the following text):

	Plan Rates 1 Percent	417(e) Minimum (Assume 5 Percent)	5.5 Percent
Accrued Benefit— Annually	\$ 180,000	\$ 180,000	\$ 180,000
Accrued Benefit— Monthly	\$ 15,000	\$ 15,000	\$ 15,000
APR age 65	207.940	141.529	135.759
Value at age 65	3,119,100	2,122,935	2,036,385
105%		2,229,082	

Absent some override to the rules under IRC Section 417(e), Maria's lump sum would indeed be over \$3 million if the plan's interest rate for actuarial equivalence was 1 percent. We find our override in the first sentence of Treasury Regulations Section 1.417(e)-1(d)(1), which states that the previous requirements are subject to the limits under IRC Section 415.

IRC Section 415(b)(1)(E) sets forth limits governing the assumptions that can be used when converting the dollar limit or percentage of pay limit³⁰ to a lump sum, and extensive guidance is provided in new Regulation Section 1.415(b)-1(c)(3). The maximum lump sum³¹ is the lesser of the actuarial equivalent of the IRC Section 415(b) limit using (1) plan rates, (2) 5.5 percent and the applicable mortality table or (3) the applicable mortality table and the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the rate (or rates) applicable in determining minimum lump sums were used. The new regulations also specify that in converting the annuity to a lump sum, monthly annuity rates (as opposed to annual rates) must be used (resulting in a payout about 4% less than what annual rates would provide).

Example. Maria's lump sum in the above would therefore be limited to \$2,036,385.

Early Termination Rule

With certain exceptions, Treasury Regulation Section 1.401(a)(4)-5(b)(3) contains a limitation on the payout of lump sums to certain employees. This rule effectively limits the payments in any given year to a restricted employee to an amount that is equivalent in value to the annual payment of the individual's accrued benefit.

A *restricted employee* is an HCE or former HCE who is one of the 25 employees (or former employees) of the employer with the largest amount of compensation in the current or any prior year. An employee is an HCE if (1) during the current or prior plan year, he or she is or was a more than 5-percent owner of the

³⁰ The IRC Section 415(b) limit.

³¹ IRC Section 415(b)(2)(E)(ii).

employer³², or (2) during the prior plan year earned more than \$100,000 (indexed). An employer may make a top-paid group election limiting the number of employees who are classified as HCEs, under the compensation rule, to 20 percent of the work force.³³

Under the regulations the restriction does not apply in the following cases:

1. After the distribution, the plan has assets adequate to cover 110 percent of an amount basically equivalent to its termination liabilities.
2. The amount of the distribution is less than 1 percent of the liabilities under the plan.
3. The distribution is less than \$5,000.

In addition to the aforementioned exceptions, the IRS will allow for an immediate lump-sum distribution under which adequate security is provided to the plan. The requirements for such security are set forth in Revenue Ruling 92-76. The Ruling provides that a lump sum may be paid if one of three types of security are provided:

1. Assets equal to 125 percent of the lump sum are kept in escrow and pledged to the plan. This might be done by rolling the distribution to an individual retirement account or annuity (IRA) that, with existing balances, would equal or exceed the 125-percent requirement. The 125-percent threshold is of the restricted amount. The *restricted amount* is the excess of the lump-sum payment over the accumulated amount that could have been taken under the life annuity, both increased with interest. If the value of the account decreased such that the assets were less than 110 percent of the restricted amount, additional assets would need to be added to the escrow account.
2. A bond is posted, equal to 100 percent of the restricted amount.
3. A bank letter of credit is issued in the amount of the restricted amount.

Under the security agreement, all or a portion of the distribution would be repayable to the plan in an amount necessary to allow the plan to pay its liabilities upon termination. This might occur if the plan were to terminate at a time when the employer was not able to fully fund the plan such that the remaining participants might receive less than 100 percent of the value of their benefits. In such a case, the IRS wants to ensure that HCEs are not allowed to receive 100 percent of their funds while others receive something less.

Example. Maria has reached the ABC plan's normal retirement age of 65. Her accrued benefit is \$180,000, with a lump-sum equivalent of \$2,036,385. There are other participants in the plan, however, and payment of the lump sum to Maria will cause the plan to fail the necessary funding requirements. Absent an adequate security arrangement, the maximum amount that Maria can receive from the plan during the year is \$180,000.

Additional distribution restrictions were added by PPA for certain underfunded plans.³⁴

³² Considering the attribution rules of IRC Section 318(a).

³³ IRC Section 414(q).

³⁴ IRC Section 436.

Adjustments to Funding

There is a common misconception that once a defined benefit plan is put into place the employer is “stuck” with a funding level similar to that in the first year. This is not the case. There are tools that the actuary and the plan sponsor have available to reduce future funding obligations when circumstances warrant. As indicated below, the ability to use certain of these tools has been hampered by PPA.

Reducing Future Benefits

One way in which funding can be reduced is by reducing future benefit accruals. In cases in which funding is based on the projected benefit (for instance, ISG funding is being used), this approach can often be used even after the end of the plan year.

Example. Maria and John are participants in ABC’s defined benefit plan, with (current and average) compensation of \$225,000 and \$35,000 respectively. The plan’s benefit formula is 8 percent of average compensation per year of participation up to a maximum of 10 years. As computed above, year one’s normal cost is \$180,499 (\$175,336 for Maria and \$5,163 for John), based on projected benefits of \$180,000 and \$28,000 for Maria and John, respectively. Two months into year three, ABC realizes that it will not be able to fund anywhere near \$180,499 for year two due to a significant reduction in cash flow. Is there anything that can be done?

IRC Section 411(d)(6) prohibits the reduction of a benefit that has been accrued. That is, at some point during a given plan year, the plan’s participants earn the right to receive the benefit that accrues during that plan year. Often, this occurs when they have achieved 1000 hours of service. Once this threshold is crossed, the benefit that has been earned cannot be amended away.

But this does not mean that *future* benefits cannot be reduced, or even eliminated altogether. Additionally, IRC Section 412(c)(8)³⁵ provides that, when determining funding for a given year, amendments made up to 2½ months after the end of the plan year may be taken into account.

Example. ABC wishes to reduce funding for year two and future years. As of the end of year two, Maria and John had accrued benefits as follows:

	Maria	John
Average compensation	\$225,000	\$35,000
Accrual rate per year	8%	8%
Accrual years to date	2	2
Accrued benefit	36,000	5,600

In February of year three, ABC adopts an amendment to the plan changing the maximum accrual years from 10 to two. Maria and John’s projected benefits are, therefore, equal to their accrued benefits. Presuming assets of \$185,000, the funding obligation for year two is now \$16,690, as follows:

³⁵ Redesignated as IRC Section 412(d)(2) by the Pension Protection Act of 2006.

Projected benefit	\$36,000	\$ 5,600
Annuity purchase rate at age 65	12.252	12.252
Future value of increase	441,072	68,611
Years to retirement (end of year)	8	28
Discount factor at 5%	.67684	.25509
Present value of projected benefit	298,535	17,502
Allocated assets	179,709	5,291
Present value of future normal cost	118,826	12,211
Normal cost	15,922	768

Due to the changes to the funding rules described in the previous text, this tool is not available for years beginning after 2007. For a plan amendment to result in a lower contribution for such a plan year it will need to be adopted in time to eliminate the current year's benefit accrual (for instance, before plan participants complete 1,000 hours of service) thereby reducing the year's target normal cost.

Changing Funding Method

Note that it takes a projected benefit method to achieve this result. That is, if the plan is being funded using the unit credit method, the year two normal cost is based on the increase in the accrued benefit occurring during year two. An amendment reducing future benefits would, therefore, have no effect on year two funding. To reduce year two's funding in such a case, it would be necessary to amend the plan before the year two benefit was earned (for example, before the participants worked 1000 hours in year two). Alternatively, the funding method could be changed.

Example. Assume the same situation as in the previous example except that ABC used unit credit funding in year one. In February of year three, it is too late to reduce the funding obligation for year two if the unit credit method is used. However, presuming the requirements to change the funding method are met, a change to ISG for year two could accomplish a result similar to that in the previous example.

Revenue Procedure 2000-40 sets forth a relatively liberal set of rules for changing funding methods without IRS approval. Although a detailed discussion of the specifics of the Revenue Procedure is beyond our scope here, a change in the overall funding method to ISG is always available if the plan has not changed its funding method in the past five years. Revenue Procedure 2000-41 sets forth rules whereby a change in method can be requested where the automatic rules are not met. But in most situations, automatic approval is available.

Again, this tool is not available for years beginning after 2007 as there is no longer any flexibility in the choice of funding method.

ERISA 204(h) Notice

Whenever a plan amendment reducing future benefit levels is adopted, employees must be given advance notice. Section 204(h) of ERISA provides that the notice must be provided within a reasonable period of time

before the amendment is effective. Failure to meet the requirements of ERISA 204(h) can result in plan participants being entitled to the higher of benefits with or without the plan amendment.

Parallel rules to ERISA Section 204(h) are provided in IRC Section 4980F. Under this IRC section, the failure to provide proper notice can result in penalties of \$100 per day. Regulations issued under IRC Section 4980F³⁶ govern both ERISA Section 204(h) and IRC Section 4980F. Q&A 9 of these regulations provides that the IRC Section 204(h) notice must be provided at least 15 days prior to the date the amendment becomes effective (45 days in the case of a plan with 100 or more participants).

An IRC Section 204(h) notice is not required for a plan under which no employees are participants covered under the plan.³⁷ Generally a plan must cover at least one employee. For this purpose, an individual and his or her spouse shall not be deemed to be employees with respect to a trade or business (whether incorporated or unincorporated), which is wholly owned by the individual or by the individual and his or her spouse. Also, a partner in a partnership and his or her spouse shall not be deemed to be employees with respect to the partnership. A plan that covers no one other than such a person (or persons) is deemed not to be an employee pension-benefit plan under ERISA and is not required to issue an IRC Section 204(h) notice if future benefits are being reduced.

Increasing Funding

Note that the ability to amend the plan up to 2½ months after the end of the plan year can also serve to increase funding. That is, if a plan is currently not providing for maximum benefits, and it is discovered after the end of the plan year that increased funding is desirable (for example, profits are greater than expected and there is a tax problem), an amendment increasing benefits can be adopted within the 2½-month period and can be considered in funding for the year just ended. This mechanism continues to be available with the passage of PPA.

Other Issues Related to Adjusting Funding

Previously, plan amendments as well as funding method changes as a way to control funding levels have been discussed. These two approaches certainly can have the biggest impact on funding.

Another possibility is a change in funding assumptions. Sometimes, the actuary can look at the facts and circumstances and determine that a higher (or lower) assumed rate of return is possible. Additionally, factors like assumed retirement ages can be adjusted. The point is that, at least to a certain extent, things can be done to control funding obligations. The important thing is that communication takes place between the plan sponsor (that is, employer) and the appropriate advisers (actuary, CPA, tax attorney, etc.). Again, the ability to use this tool has been greatly decreased with the passage of PPA and the related required funding assumptions.

Minimum Participation

Besides meeting the minimum coverage and nondiscrimination rules applicable to all plans, defined benefit plans are subject to a special set of rules under IRC Section 401(a)(26). Under this section, a defined benefit plan generally must cover the lesser of (1) 50 employees or (2) the greater of (a) 40 percent of the employer's

³⁶ Regulation Section 54.4980F-1.

³⁷ As described in ERISA Regulation Section 2510.3-3(b).

nonexcludable employees or (b) 2 employees. If there is only one nonexcludable employee, then the plan need not meet the two-employee minimum.

Nonexcludable employees are generally those employees who are not excludable under IRC Sections 410(b)(3) and 410(b)(4)(A). Excludable employees include (1) nonresident aliens with no U.S. source income; (2) union employees in which retirement benefits have been the subject of good-faith bargaining; and (3) employees who have not met minimum age and service requirements (generally 12 months of service and the attainment of age 21, but in certain cases 24 months of service and the attainment of age 21).

Pension Benefit Guaranty Corporation

Under Title IV of ERISA, certain defined benefit plans must purchase termination insurance coverage from the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a federal corporation, created by ERISA, to encourage the continuation and maintenance of defined benefit pension plans. The PBGC protects the retirement incomes of nearly 44 million American workers in more than 30,000 private defined benefit pension plans.

PBGC coverage provides benefits to participants of covered plans in which assets are insufficient to do so (up to a maximum). The maximum benefit the PBGC will guarantee is \$49,500 for 2007. The current annual premium for PBGC covered plans is \$31 per participant, with an additional "variable rate premium" for plans that do not meet certain funding levels.

Under ERISA Section 4021(b), certain plans are excluded from PBGC coverage. Noncovered plans include the following:

1. Defined contribution plans.
2. Plans covering only substantial owners³⁸ of at least 10 percent of a trade or business, whether or not incorporated. (In determining ownership the constructive ownership rules of IRC Section 1563(e) apply.)
3. Plans established and maintained by a professional service employer which does not *at any time* have more than 25 active participants.³⁹
4. Unfunded deferred compensation plans maintained primarily for the purpose of providing deferred compensation for a select group of management or HCEs.⁴⁰
5. Excess benefit plans.⁴¹
6. Church plans in which no election has been made to be covered by ERISA.
7. Most government plans.
8. Plans that are fully funded by employee contributions.
9. Plans established outside the United States for nonresident alien employees.

³⁸ ERISA Section 4022(b)(6).

³⁹ It is under this exception that small medical, dental, and other professional practices escape PBGC coverage.

⁴⁰ Often referred to as top-hat plans or nonqualified deferred compensation plans.

⁴¹ Nonqualified plans maintained to provide benefits in excess of the limits of IRC Section 415(b).

Defined Benefit Plan Termination

Upon termination of a defined benefit plan, the remaining participants become 100-percent vested to the extent the plan is funded at such time.⁴² If the plan is subject to coverage by the PBGC, participants must be notified at least 60 days prior to the termination of the intent to terminate the plan.⁴³ In a non-PBGC plan, the notification period is effectively the 15- or 45-day period required under ERISA Section 204(h) discussed above.

Additionally, in the case of a PBGC-covered plan, the plan assets must be sufficient to meet the plan's liabilities. Basically, this means that the plan must be able to pay out to each participant the lump sums required under IRC Section 417(e). If assets are insufficient at the time, the employer will need to make up the deficiency by making additional deposits into the plan.⁴⁴

Majority Owner Waiver

In certain circumstances, the requirement to make the plan sufficient can be satisfied by a *majority owner waiver*.⁴⁵ A majority owner is a 50-percent or more owner of the plan sponsor. Ownership is determined, taking into account the constructive ownership rules of IRC Sections 414(b) and (c). Such a waiver results in the majority owner foregoing the receipt of his or her plan benefits to the extent necessary to enable the plan to satisfy all other plan benefits. In order to be valid the majority owner's spouse must consent to the waiver of benefits.

Example. Maria owns 100 percent of ABC. The ABC defined benefit plan is terminated at a time when the present value of Maria's accrued benefit is \$500,000, and the present value of John's accrued benefit is \$50,000. There is a total of \$450,000 of assets in the plan. There are two choices here. ABC can contribute the amount needed to fully pay Maria and John (\$100,000). Alternatively, Maria, with her spouse's consent if she is married, can sign a majority owner waiver, agreeing to take a lesser amount (\$400,000 instead of the \$500,000 present value of her benefit).

It is important to note that a plan sponsor that has no majority owners may not use the majority owner waiver to reduce the obligation to fully fund the plan at termination.

Example. Assume that ABC is equally owned by Maria and two other individuals who are not actively involved in the operation. ABC would have no choice but to fully fund the \$100,000 shortfall. Since Maria is not a majority owner, she could not elect to forego a portion of her benefit.

In the case discussed above, the PBGC-covered plan is able to meet its liabilities to the satisfaction of the PBGC. That means all benefit liabilities are met, or all benefit liabilities are deemed to be met via a majority owner waiver. If a plan terminates in satisfaction of this requirement, it is known as a standard termination, meaning that the PBGC is basically uninvolved.

If this is *not* the case, the PBGC gets involved and a distress termination ensues. This is a complicated, unpleasant set of events, likely resulting in the PBGC at least placing a lien on the plan sponsor's assets.⁴⁶

⁴² IRC Section 411(d)(3).

⁴³ ERISA Section 4041(a)(2).

⁴⁴ ERISA Section 4041(b)(1)(D), ERISA Regulation Section 4041.28(a)(1).

⁴⁵ ERISA Regulation Section 4041.21(b)(2).

⁴⁶ ERISA Section 4041(c) and ERISA Regulation Section 4041.41.

Cash Balance Plans

We have previously determined that in a defined contribution plan, a separate accounting is maintained for each employee and each year the account is credited with the actual contribution and actual earnings. That is, the contribution is what is defined and limited to the lesser of \$45,000 or 100 percent of compensation.

Conversely, in a defined benefit plan, the plan determines what will come out at the end. That is, the benefit is what is defined. An actuary then determines the annual amount that must be deposited into the plan to provide such benefits. In addition to the benefits, the actuary takes into account an expected rate of return, in addition to other factors (for instance, mortality) when determining the required contribution. The actual investment results serve to cause the required contribution to increase or decrease over time based on whether or not they exceed projected returns.

In a traditional defined benefit plan, a participant will receive a retirement benefit defined as some percentage of pay or some flat dollar amount. For example, a plan might provide for a benefit of 2 percent of pay for each year of participation in the plan. A participant with 25 years of participation would, therefore, retire at 50 percent of pay. Alternatively, a defined benefit plan might provide for a monthly retirement benefit of \$50 for each year of service with the employer. A participant with 20 years of service would then receive a retirement benefit of \$1,000 per month.

As discussed above, there is no maximum contribution that can be made to a defined benefit plan, *per se*. Instead, from our discussion above, we learned that the ultimate amount that comes out at the end is limited.

A cash balance plan is a hybrid between a defined contribution plan and a defined benefit plan. It is a defined benefit plan that looks (to the participant) like a defined contribution plan. Legally, it is a defined benefit plan since it does not meet the definition of a defined contribution plan. That is, it is not a plan in which the benefit is based solely on amounts contributed to an individual's account and the actual earnings on such account. Therefore, the defined benefit limits apply, and the annual contribution on behalf of any participant is *not* limited to \$45,000. Instead, the ultimate retirement benefit cannot exceed the defined benefit limits under IRC Section 415(b) indicated previously (the lesser of the dollar limit or the percentage of pay limit).

In a cash balance plan, a hypothetical account is maintained on behalf of each participant. On an annual basis, this account is credited with a contribution credit and an earnings credit. The contribution credit can be a flat dollar amount or a percentage of pay and can vary by employee. Again, the contribution credit is not limited to the annual defined contribution limits.

The earnings credit is often (but not always) based on the applicable interest rate set forth under IRC Section 417(e). The plan is a defined benefit plan because the contribution credit and the earnings credit are guaranteed to the employee, that is, the amount that the employee will receive at retirement is defined. If the plan earns more or less than the earnings credit, future contributions are modified. Under PPA, a cash balance plan must provide interest credits of no more than a market rate of return.⁴⁷ As of this writing, this term is undefined. In Notice 2007_06, the IRS provided a list of rates that will be considered a market rate, as follows:

- The rate of interest on long-term investment grade corporate bonds as described in IRC Section 412(b)(5)(B)(ii)(II) prior to amendment by PPA '06 for plan years beginning prior to January 1, 2008.
- The third segment rate described in IRC Section 430(h)(2)(C)(iii) for subsequent plan years.
- The rate of interest on 30-year Treasury securities as described in IRC Section 417(e)(3) prior to amendment by PPA '06.

⁴⁷ IRC Section 411(b)(5)(B)(i).

- Any of the standard indexes and the associated margin for that index as described in part IV of Notice 96-8.

PPA also requires that cash balance plans provide for a vesting schedule resulting in 100 percent vesting after 3 years.⁴⁸

In the following section, we will see how a cash balance plan can work well in a professional setting.

Case Study

In this section, we will bring some of the preceding discussion of funding methods and cash balance plans together while considering alternative plan designs for a professional corporation we will refer to simply as PC. For our purpose, we will assume there are six equal shareholders in PC and that they are the only employees. PC has never had a defined benefit plan. The census for PC looks as follows:

	Age	Earnings
Shareholder 1	60	\$225,000
Shareholder 2	55	225,000
Shareholder 3	52	225,000
Shareholder 4	50	225,000
Shareholder 5	48	225,000
Shareholder 6	45	225,000

Maximum Defined Benefit Plan

Consider first a defined benefit plan designed to provide each shareholder with the maximum allowable benefit. Recall from above that, in 2007, the maximum benefit is \$180,000 annually beginning at age 62 through 65. Recall, also, that in order to achieve this benefit, the employee must participate in the plan for at least 10 years. Accordingly, shareholder 2 will be able to receive the full \$180,000 benefit only if he remains a participant in the plan until age 65. At age 65, shareholder 1 will have only 5 years of participation such that his benefit at such time cannot exceed \$90,000.

To achieve the full benefit over a 10-year period, shareholder 2 will need to accrue a benefit of \$18,000 each year. With compensation of \$225,000, this represents 8 percent of compensation. So the plan's benefit formula will be 8 percent of compensation per year of participation, to a maximum of 10 years.

For funding purposes, we will assume pre- and postretirement interest at 5.5 percent and the mortality table from Revenue Ruling 2001-62. Normal costs using ISG and unit credit funding are as follows:

⁴⁸ IRC Section 411(a)(13)(B).

	ISG	Unit Credit
Shareholder 1	\$189,834	\$171,046
Shareholder 2	164,575	130,873
Shareholder 3	115,874	111,453
Shareholder 4	94,560	100,136
Shareholder 5	78,490	89,967
Shareholder 6	60,770	76,617
Total	\$704,103	\$680,092

There is a relatively small difference in total funding when comparing the two funding approaches. However, on an individual basis, the funding difference is significant. For example, the funding cost for shareholder 2 is over \$33,000 more using ISG than that using unit credit funding. If costs are accounted for in determining total compensation, this cost differential is important.

Recall from our discussion of funding methods that unit credit funding most closely follows benefit obligations. We noted, in discussing payment of benefits, that in small plans, most employees take a lump sum and that the amount of the lump sum is the present value of the accrued benefit. What is the present value of the accrued benefit at the end of year 1? Well, if the funding assumptions match actuarial equivalence, it is equal to the normal cost under unit credit funding. Accordingly, if costs are accounted for in determining total compensation, unit credit funding makes a lot of sense.

Cash Balance Plan

Not all groups want to fund at the levels shown above, and often the difference in cost is an issue notwithstanding the ability to even things up outside the plan. In such a case, a cash balance plan would work well for PC.

A cash balance plan could be designed, for example, providing for an annual contribution credit of \$76,600, such amount to be credited on the last day of the plan year. We chose \$76,600, because this is the closest amount to lowest maximum present value shown above. That is, since the plan above maximized benefits under a traditional defined benefit plan, a contribution credit in excess of the \$76,600 could result in a benefit that could not be paid if shareholder 6 terminated early. We explain this in more detail in the following paragraphs.

Again, a cash balance plan is a defined benefit plan. As such, the benefit limits of IRC Section 415(b) apply. Recall that this section limits the annual benefit, in the form of a life annuity, that a participant may receive from the plan based on age at retirement as well as other factors. What is this annuity in a cash balance plan?

It is the monthly payment that would be paid if the hypothetical account balance is projected out to normal retirement age using the plan's interest crediting rate, and this amount were then used to purchase an annuity.

Let's look at the numbers for shareholder 6. For our purposes, we will assume that the applicable interest rate is 5.5 percent and that the plan's interest rate for actuarial equivalence is the applicable interest rate. Additionally, the plan uses the applicable mortality table (the table in Revenue Ruling 2001-62) for actuarial

equivalence. The applicable interest rate is also used for providing the earnings credit, the interest credit added to the hypothetical account balance at the end of each year.

Account balance at the end of year one	\$ 76,600
Attained age at end of year one	46
Years to age 65 (normal retirement age)	19
Accumulation factor at 5.5%	2.766
Projected accumulated amount at age 65	211,876
Annuity purchase rate	11.772
Accrued benefit (\$211,876/11,772)	\$ 18,000

A contribution credit in excess of \$76,600 would result in an accrued benefit at the end of year one for shareholder 6 in excess of his maximum accrued benefit at that time. In other words, the maximum benefit that shareholder 6 could accrue is \$180,000, but that is only after 10 years of plan participation. After one year of plan participation, his maximum accrued benefit is one-tenth of this amount, or \$18,000.

Note that a contribution credit in excess of \$76,600 could be credited to shareholder 6; it just could not be paid right away. Note what happens in year two. In the following table, we assume that the applicable interest rate stays at 5.5 percent:

Account balance at beginning of year two	\$ 76,600
Earnings credit at 5.5%	4,213
Year two contribution credit	76,600
Account balance at the end of year two	157,413
Attained age at end of year one	47
Years to age 65 (normal retirement age)	18
Accumulation factor at 5.5%	2.621
Projected accumulated amount at age 65	412,579
Annuity purchase rate	11.772
Accrued benefit (\$412,579/11.772)	\$ 35,047

At the end of year two, shareholder 6's accrued benefit is \$35,047. His maximum accrued benefit, however, would be \$36,000. A little math will show you that this is equivalent to a hypothetical account balance at the end of year two of about \$162,000. This would support a contribution credit of about \$78,500 annually. So, a contribution credit in excess of \$76,600 would be permissible. Nevertheless, the early termination could result in a scenario in which it could not be paid out. Whether or not it could be funded depends on the funding method being used. If an excess contribution credit is being funded, and early termination results in an accrued benefit that cannot be paid, it is not unusual to have something in the severance plan of a shareholder compensating him outside the plan for funded benefits that cannot be paid by the plan.

Combination Plans

It is possible that not all of the shareholders wish to fund at the levels above. Indeed, some of the shareholders may be happy at the maximum defined contribution level of \$45,000 (the limit for 2007). In such a case, certain of the shareholders could be written out of the defined benefit plan and a defined contribution plan could be set up for these shareholders. The important thing to remember is that the minimum participation rules of IRC Section 401(a)(26) must be followed. In PC's case, this means that at least three of the six shareholders would need to be covered by the defined benefit plan.

Note that if any of PC's shareholders wished to be in both plans, a deduction limit could cause a problem. IRC Section 404(a)(7) imposes a deduction limit affecting companies that sponsor both a defined benefit plan and a defined contribution plan and at least one employee is a participant in both plans. For a thorough discussion of IRC Section 404(a)(7), see Chapter 12, "Deduction Issues."

If IRC Section 404(a)(7) applies, the maximum deductible amount is the greater of 25 percent of compensation or the amount required to be deposited into the defined benefit plan to meet its minimum funding requirements for the year. In measuring the deductible limit, compensation is limited to the maximum compensation includible under IRC Section 401(a)(17), which is \$225,000 for 2007.

In PC's case, any crossover participation would result in a deductible limit of \$337,500. In determining this amount, however, elective deferrals to 401(k) plans are not included.⁴⁹

Let's take a look, then, at what could be accomplished if shareholders 1 to 3 each wish to shelter \$103,500, but shareholders 4 to 6 each wish to shelter only the defined contribution plan maximum. The design could take on the following characteristics:

- Each shareholder defers the maximum into the 401(k) plan.
- Each shareholder receives an allocation of \$29,500 under a profit-sharing plan.
- A cash balance plan is established covering shareholders 1, 2, and 3 only. Shareholders 4, 5, and 6 are excluded from plan participation.
- A contribution credit of \$53,500 is provided for each participant in the cash balance plan.
- Cash balance funding equals contribution credits.

The numbers would work out as follows:

	Profit Sharing	401(k)	Cash Balance	Total
Shareholder 1	\$ 29,500	\$20,500	\$ 53,500	\$ 103,500
Shareholder 2	29,500	20,500	53,500	103,500
Shareholder 3	29,500	20,500	53,500	103,500
Shareholder 4	29,500	20,500	—	50,000
Shareholder 5	29,500	15,500	—	45,000
Shareholder 6	29,500	15,500	—	45,000
Total	\$177,000	\$113,000	\$160,500	\$450,500

⁴⁹ IRC Section 404(n).

Remember that the 401(k) deferrals are not counted in determining the deductible limit. So, only the cash balance contribution and the profit-sharing contribution must be considered. These amounts total \$337,500, the deductible limit as indicated above.

The Pension Protection Act of 2006 added IRC Section 404(a)(7)(C)(iii). This section provides that, in the case of employer contributions to one or more defined contribution plans, the 25% limit applies only to the extent that such contributions exceed 6 percent of the compensation paid during the taxable year to the beneficiaries of the defined contribution plans.

If each of the shareholders wished to participate in the cash balance plan, and the goal is to provide equal credits, using a special 6 percent rule under IRC Section 404(a)(7)(C)(iii), the following result might be achieved.

	Profit-Sharing	401(k)	Cash Balance	Total
Shareholder 1	\$ 13,500	\$20,500	\$ 75,000	\$ 109,000
Shareholder 2	13,500	20,500	75,000	109,000
Shareholder 3	13,500	20,500	75,000	109,000
Shareholder 4	13,500	20,500	75,000	109,000
Shareholder 5	13,500	15,500	75,000	104,000
Shareholder 6	13,500	15,500	75,000	104,000
Total	\$ 81,000	\$113,000	\$450,000	\$ 644,000

In Notice 2007-28 the IRS concluded that the language of IRC Section 404(a)(7)(C)(iii) increases the limitation from 25% to 31% where contributions to the defined contribution plans exceed 6% of compensation. That is, per Q&A 8 of the Notice, the first 6% of contributions to defined contribution plans are effectively ignored when applying the 25% limit. This provides for the following result in the first example above:

	Profit-Sharing	401(k)	Cash Balance	Total
Shareholder 1	\$ 29,500	\$20,500	\$ 80,500	\$130,500
Shareholder 2	29,500	20,500	80,500	130,500
Shareholder 3	29,500	20,500	80,500	130,500
Shareholder 4	29,500	20,500	—	50,000
Shareholder 5	29,500	15,500	—	45,000
Shareholder 6	29,500	15,500	—	45,000
Total	\$177,000	\$113,000	\$241,500	\$531,000

Again, the 401(k) deferrals are not counted in determining the deductible limit. The cash-balance contribution and the profit-sharing contribution total \$418,500, or 31% of \$1,350,000.

Chapter 11

Fully Insured Defined Benefit Plans— Internal Revenue Code Section 412(i) (Also Known As Code Section 412(e)(3))

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This chapter provides a basic discussion of a type of defined benefit plan known as a fully insured defined benefit plan. We will focus on the traditional concept of this type of plan, though, in recent years, a number of particularly aggressive fully insured designs have been heavily sold by some high-powered marketing organizations and have come under scrutiny by the Internal Revenue Code (IRC). For years, this provision has been located at IRC Section 412(i), but as a result of the Pension Protection Act of 2006, it is has been relocated to 412(e)(3), but we will still refer to it as a 412(i) plan at this time.

Definition

A *412(i) plan* is a defined benefit retirement plan, the funding requirement of which falls under IRC Section 412(i). If a plan meets the requirement of this subsection, it is exempt from the complex funding rules of IRC Section 412 applicable to all other defined benefit plans.

A 412(i) plan is *only* different in the area of funding. It must meet all requirements of IRC Section 401 regarding qualified plans.

Requirements

A 412(i) plan must be funded exclusively with annuity contracts or a combination of insurance and annuity contracts. The contracts must provide for level annual premium payments to begin when the individual becomes a plan participant and extending not later than the retirement date under the plan. Dividends, when payable, must be used to reduce the premium of the contracts.

The plan benefit must be provided entirely by these contracts and guaranteed by an insurance carrier to the extent premiums have been paid. There is an exception that allows for a separate accumulation fund for providing top-heavy minimum benefits. This usually applies only in the early years of a participant's

participation in the plan and only until the cash value of the contracts grows to an adequate enough amount to provide at least the minimum top-heavy benefits on their own.

Premiums (for current and all prior plan years) must have been paid. No rights under the contracts may be subject to a security interest during the plan year and no policy loan may be outstanding at any time during the plan year.

Advantages of 412(i) Plans

Unlike the more common type of defined benefit plan, there is no full funding limitation or current liability test applied to limit the deduction to a 412(i) plan.

In a traditional fully insured plan, the assets (which are the values of the contracts) are exactly equal to the monthly benefits payable to participants. This means that, by definition, there can be no overfunding of the monthly benefit. No overfunding means that there would be no reversion penalty tax because there would not be any leftovers reverting to the employer in the event of plan termination.

However, there can be an overfunding if lump-sum payments are intended and the guaranteed amounts under the contract exceed the IRC Section 415 maximum for the lump-sum values that are payable to the participant.

Similarly, there can be no underfunding in a 412(i) plan since the payment of the required premium will always keep the accrued benefits equal to the amount of benefits provided by the contracts. If a 412(i) plan terminates, the plan sponsor will not have to come up with additional funds in order to fully pay out the participants the amounts to which they are entitled, since the amounts they are entitled to are simply the amounts in the contracts.

Unlike the non 412(i) defined benefit plan, generally no enrolled actuary needs to be involved in a 412(i) plan. The actuaries who determined the pricing and values of the contracts have provided a prepackaged program: Simply pay the premium and you will always have the right amount of benefits. No actuary's statement (the Schedule B attachment to the 5500 annual return for the plan) is required for a fully insured defined benefit plan (unless there is a top-heavy accumulation fund as noted above).

A regular defined benefit plan requires that quarterly contributions are to be made. That is not the case in a 412(i) plan, but premiums *must* be paid as they are due (there is no flexibility regarding the timing of the payments, which might be considered a more rigorous requirement than required quarterly contributions).

Significantly larger contributions (deductions) are available than would be the case in a traditional defined benefit plan.

Plan funding assumptions should not be subject to attack by the Internal Revenue Service (IRS), since the assumptions are mandated to be the guarantees in the insurance company contracts. Nonetheless, the IRS is well aware of the aggressive product marketing and is attempting to shut them down, as they have done with voluntary employees' beneficiary associations (VEBA) plans.¹

¹ A VEBA (also known as an IRC Section 419A plan) is a tax-exempt organization, as described in IRC section 501 (C) (9), that has received a tax exemption letter from the IRS. The VEBA usually provides for the payment of life, accident, sickness, and other benefits to the participants in the VEBA, their dependents or beneficiaries. In most cases, a VEBA is set up as a trust with a bank as the trustee. The earnings of a VEBA trust are tax-exempt.

Since 1928 Congress has permitted businesses to use VEBAs to provide welfare benefits. Welfare benefits are payable upon the occurrence of an event that is not necessarily within the control of the benefit recipient (for instance, life insurance payable upon the death of a covered employee).

VEBAs are subject to some provisions of ERISA; however they are not subject to the rules governing qualified plans. The IRS has proposed certain guidelines with which VEBAs must comply. A properly designed VEBA receives a letter of determination from the IRS granting it tax-exempt trust status.

Benefits are guaranteed by the insurance company. This means the insurance company bears the investment risk. The contract values are not influenced by market fluctuations and, therefore, the contracts provided a relatively conservative rate of return.

Employer funding of the plan is simpler to understand than a traditional defined benefit plan, since the plan sponsor simply pays the premiums as they become due.

The nature of the insurance contract funding generally leads to high contributions in the early years of the plan's operation. As dividends on the contracts tend to increase over time, future premiums will be reduced by the increasing dividends payable on the insurance contracts.

By the operation of the insurance contracts, it is possible to totally fund benefits early. At some point, the dividend could be equal to the premium, thus requiring no additional contributions from the plan sponsor. Additionally, in a maximum benefit situation in which lump-sum distributions are contemplated, it may be appropriate to stop premium payments early so as not to have the contract values exceed what can actually be paid out to the participants under the IRC Section 415 limits.

The use of insurance contracts and the lack of required actuarial services could possibly result in lower administrative fees to operate the IRC Section 412(i) plan.

Disadvantages of 412(i) Plans

- There is no flexibility in investments. The assets must be held by an insurance company in insurance contracts.
- Premiums must be paid as they come due. There is no flexibility in the timing of contributions, and no policy loans are allowed.
- The premiums are determined by insurance company product rates. There is no flexibility in payments or costs.
- No participant loans are allowed in a 412(i) plan, though some administrators might suggest that the lack of participant loans and the reduced administrative complexity that the elimination of those loans brings to the administration of a plan might be considered an advantage.

Who Is the Ideal Prospect?

The ideal prospect for a 412(i) plan is a small business. Generally, we would expect to find a highly paid owner, age 40 to 75. In the best situation, there are few other employees (or none). If there are other employees, it is best if they are younger than the owner and relatively low paid. An alternative good prospect situation is that all other employees are family members.

The ideal candidate would have a strong stability of business income (profits) and a desire to maximize deductions to the retirement plan. Investment flexibility must not be an important objective.

Designing Fully Insured Plans Under GATT Limitations

The funding contracts have minimum guarantees that are used to determine the premiums to be paid.

Typically, the funding contracts provide for sharing the actual, higher rate of return earned on the contract premiums with the contract owner through dividends or excess interest credit paid to the policy holder. As noted earlier, these dividends must be used to reduce the premium.

The nature of dividends is that they will increase over time, thus lowering the cost of the 412(i) plan year by year. That is why the 412(i) plan contributions will be greater in the early years and will decrease over time if the benefit otherwise stays the same.

A traditional defined benefit plan, as a result of full funding limitations built into the law, tends to have a pattern of increasing costs over time. Reduced (limited) early year costs are pushed off to future years during which they must ultimately be funded.

A 412(i) plan is subject to the same maximum benefit limitations and top-heavy provisions as a traditional defined benefit plan.

The 1994 General Agreement on Tariffs and Trade (GATT) included the Retirement Protection Act (RPA 94) which limits the maximum defined benefit payout. The maximum lump-sum equivalent of the maximum monthly benefit is based on a specified mortality table (the 50/50 blended male/female table) and an interest rate based on the 30-year Treasury securities, which, by the way, are no longer in existence!² This interest rate changes monthly.

If the participant takes the benefit as an annuity payout, there is no problem with the above. However, if the participant takes a lump sum (and when was the last time you saw an annuity payout in a small business defined benefit plan), the lump-sum value under the guaranteed contract conversion factor could be 40 percent higher than the maximum amount determined under the GATT rates.

If the participant takes the maximum lump sum, it could leave excess assets in the plan after the participant retires. If not reallocated to remaining participants, this would revert to the employer and be subject to the applicable 50-percent excise tax (plus ordinary income taxation). Under current law, the maximum retirement benefit is limited to annual payments of \$160,000 per year.

Generally, there are two approaches to addressing this excess asset problem inherent in the 412(i) design, namely, the safe approach and the aggressive approach. These are discussed in the following sections. In addition, there is also a middle ground approach, which is also discussed, in a separate section.

Safe Approach

Determine an assumed GATT interest rate at retirement age to determine the maximum lump-sum payout available.

Use the insurance company guaranteed rate to determine the equivalent guaranteed annuity amount of the GATT maximum. This will be a monthly benefit *lower* than the maximum statutory monthly benefit that could be provided if an annuity was actually taken instead of a lump sum.

Use this lower monthly benefit as the maximum in determining the formula for the 412(i) plan. At retirement, the lowered monthly benefit would produce the maximum GATT payout.

This design will generally still provide larger current deductions than a traditional defined benefit plan because the interest rate assumed in the contract is usually around 3 to 4 percent versus the possible 6- to 8-percent rate that might be used by the actuary in funding the traditional plan.

² The 30-year Treasury constant maturity series was discontinued as of 2/18/02. For Public Debt information contact US Treasury Office of Debt Management at (202) 219-3350 or visit www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/.

Aggressive Approach

Under an aggressive approach, the excess asset problem inherent in the 412(i) design is addressed as follows:

1. Fund for the maximum annuity (knowing that excess assets will accumulate that cannot be paid as a lump sum).
2. Fund the plan for a limited number of years at the maximum.
3. Freeze the plan when the current contract values, projected at the actual *expected* rate of return, would grow to be equal to the GATT 415 maximum at retirement. The contracts would either be put on a paid-up option or surrendered, depending on the desires and needs of the client.
4. The plan ceases to be a 412(i) plan at this point and is now subject to actuarial certification.
5. At a later date, the plan can be unfrozen by amendment and the formula increased to use up the excess.

It should also be noted that the GATT 415 maximum dollar limit and corresponding lump-sum payout limit would be subject to cost-of-living adjustments (COLAs) increases which could help eat up the excess assets (and provide an even larger payout than the original calculations).

Middle-Ground Approach

The middle-ground approach is accomplished by the following steps:

1. Fund the plan for a limited number of years at the maximum deductible level.
2. Terminate the plan prior to retirement while the assets do not yet exceed the GATT limit. This requires monitoring the plan and the GATT rates each year to determine when the benefits are nearing the limits and terminating the plan in the year prior to the time when the GATT limit would be exceeded.
3. Roll over the defined benefit assets into an IRA or other defined contribution plan.

This process generally would require the services of a professional pension consulting/administration firm to monitor the plan and make the necessary calculations to prevent the plan assets from exceeding the GATT limits.

Top-Heavy Rules

A 412(i) plan must satisfy the top-heavy provisions of IRC Section 416.

A plan is considered top heavy if more than 60 percent of its accrued benefits inure to the benefit of key employees. Generally, this means owners of 5 percent or more of a business and other highly compensated employees (HCEs).

It should be expected that every 412(i) plan will be top heavy and have to meet the IRC Section 416 rules. The top-heavy rules require that a plan must normally provide a minimum monthly retirement benefit of 2 percent of compensation per year of service for each top-heavy year up to a maximum of 10 years to a maximum of a 20-percent monthly benefit.

A problem is that this top-heavy minimum accrues rapidly and the level premium contracts may not have sufficient cash to guarantee the accrued benefit in the early years of the plan.

There are two possible solutions to the top-heavy issue. The first is to solve the problem through plan design, by having a benefit formula that is much higher than the minimum top-heavy requirements so that the minimum top-heavy minimum accruals are met by the actual cash accumulations in the early years of the higher formula.

It is permissible to provide additional funding outside the whole life insurance and annuity contracts without jeopardizing the plan's fully insured status. A small separate account can be established to fund the minimum accruals in case the employee (or the plan) terminates in the early years of participation. Note that plans utilizing this method of meeting top-heavy minimums will be required to have actuarial certification and Schedule B filings with regard to this accumulation fund.

Conversion of Existing Defined Benefit Plans

An existing defined benefit plan can be converted into a 412(i) plan. Revenue Ruling 81-196 outlines the procedures for converting existing defined benefit plans that are not fully insured to fully insured plans.

Existing accrued benefits at the time of the conversion must be funded with single premium retirement annuities (SPRS) that have a cash value equal to the present value of the accrued benefits for the plan as of the conversion date.

The guaranteed projected benefit at retirement provided by the SPRA is used to offset the total benefits provided under the fully insured plan at retirement, with the balance provided just as it would be under a new fully insured plan.

In order to become a 412(i) plan, all existing assets of the old defined benefit plan must be transferred to the insurance company so that the benefits become guaranteed by the insurance company.

Conversion as Insurance Company Solution to Overfunded Defined Benefit Plan

Reputable insurance companies often offer a fully insured conversion as a solution to absorb excess assets from an existing defined benefit plan. This supposedly reduces the possibility of the 50-percent excise tax for reversion.

However, this will only work if the participants are either not near their GATT 415 limit, or want to take an annuity payout.

As an alternative, if they are not near their GATT 415 limit, then the plan could be amended to simply increase the benefit levels to absorb the excess assets.

And, if they want to take an annuity payout, annuities could be bought by the traditional defined benefit plan and that would accomplish the same absorption of excess assets.

Abusive Designs

There are a number of marketing organizations aggressively marketing very attractive illustrations of fully insured plans; perhaps too attractive. What are the problems?

Most of them are predicated on some limited payment of premiums and then terminating the plan and rolling out the insurance while it has low cash values (via high surrender charges).

The companies claim they are not springing cash value contracts, but they sure smell like them. One illustration I reviewed shows three annual premiums of \$100,000 and a cash surrender value at the end of

three years of \$25,420. It is not unusual for such a policy to provide a commission equal to 100 percent of the first year's premium with significant renewal commissions as well.

The IRS and the Department of the Treasury are fully aware of these deals and are actively auditing them. They have indicated that they will shut them down if they are found to be abusive. Given their recent record of pursuing and shutting down abusive IRC Section 419A (VEBA) plans, the IRS and the Department of the Treasury are confident of the success of their project.

Bottom line: 'If it sounds too good to be true, it probably is.'

Comparison With Other Plans

The following table compares the fully insured defined benefit plan to other plans.

First-Year Contributions						
	Attained Age/ Retirement Age	Contributions			Percent Higher for Fully Insured Plans	
		Defined Traditional Contribution	Defined Benefit*	Fully Insured*	Defined Contribution	Traditional Defined Benefit
Ethan	45/62	35,000	75,160	145,236	315%	93%
Steve	50/62	35,000	128,166	236,305	575%	84%
Jeff	55/62	35,000	188,209	332,357	850%	77%
Jim	60/65	35,000	194,847	338,216	866%	74%

* In IR-2004-21 (Feb. 13, 2004) IRS Warns of Abusive 412i Plans.

The Treasury Department and the IRS issued guidance to shut down abusive transactions involving specially designed life insurance policies in retirement plans, IRC Section 412(i) plans. The guidance designates certain arrangements as "listed transactions" for tax-shelter reporting purposes. For additional information, see:

- Revenue Ruling 2004-20, Abusive Transactions Involving Insurance Policies in IRC 412(i) Retirement Plans, <http://www.irs.gov/pub/irs-utl/rr-04-20.pdf>.
- Revenue Ruling 2004-21, <http://www.irs.gov/pub/irs-utl/rr-04-21.pdf>.
- Proposed Regulation 126967-03, <http://www.irs.gov/pub/irs-utl/402reg.pdf>.
- Revenue Procedure 2004-16, <http://www.irs.gov/pub/irs-utl/rp-04-16.pdf>.
- News Release IR-2004-21, <http://www.irs.gov/pub/irs-utl/ir-04-021.pdf>.

Chapter 12

Deduction Issues

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One of the primary attractions of qualified retirement plans is tax leverage. If the rules are properly followed, the employer obtains a tax deduction for the contribution to the plan while the employee is not taxed until he or she receives the dollars from the plan (assuming the plan remains tax qualified under Internal Revenue Code (IRC) Section 401(a)). Additionally, under IRC Section 501(a), the earnings of the plan are not taxed until distribution.

The combination of this favorable tax treatment provides for powerful tax planning. This chapter will discuss the rules of IRC Section 404 regarding the ability to deduct contributions to single employer qualified retirement plans. In this chapter, you'll learn about required contributions, and respective limitations, for tax deductible contributions to qualified retirement plans and learn about requirements relating to the timing of making plan contributions to such plans.

General Rule

IRC Section 404(a) begins “If contributions are paid by an employer to a stock bonus, pension, profit-sharing, or annuity plan such contributions shall not be deductible under this chapter; but, if they would otherwise be deductible, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible . . .”

This opening paragraph tells us two things:

1. Contributions to qualified plans are not deductible under IRC Section 162 as ordinary and necessary business expenses; and
2. If such contributions otherwise meet the requirements of IRC 162 (for example, they are reasonable) then they are deductible under IRC 404(a), subject to the limits thereunder.

The limits of IRC Section 404 vary depending on the type of plan or plans involved. The principal provisions of IRC Section 404 that will be discussed in this chapter include the following:

1. IRC Section 404(a)(3) regarding deduction limits for contributions to defined contribution plans;
2. IRC Section 404(a)(1) regarding deduction limits for contributions to defined benefit plans for tax years beginning prior to 2008;
3. IRC Section 404(o) regarding deduction limits for contributions to defined benefit plans for tax years beginning after 2007;
4. IRC Section 404(a)(7) regarding deduction limits when the employer maintains one or more defined benefit plans and one or more defined contribution plans;
5. IRC Section 404(a)(6) regarding the timing of payments;
6. IRC Section 404(a)(8) regarding special limits in the case of self-employed persons;
7. IRC Sections 404(a)(12) and 404(l) regarding the definition of compensation; and
8. IRC Section 404(n) regarding the treatment of elective deferrals.

Defined Contribution Plans

A defined contribution plan (that is, a profit sharing, stock bonus or money-purchase plan) is allowed a deduction of up to 25 percent of the compensation paid to beneficiaries of the plan during the *employer's tax* year.¹ If the contributions are made to two or more such plans, such plans shall be considered a single plan for purposes of applying the 25 percent limit.²

It is important to note that the 25 percent limit is a plan level limit. That is, the allocation to any one participant under the plan is not limited to 25 percent of such participant's compensation. Rather, IRC Section 415(c)(1) provides for an individual limit of the lesser of the dollar limit (\$45,000 for plan years ending in 2007) or 100 percent of the participant's compensation for the year. (The dollar limit is increased by the amount of catch-up contributions, for individuals 50 years of age or older, available under IRC Section 404(v), up to \$5,000 for 2007.)

Example. Company A employs a workforce of 20 union employees and two non-union employees (the owner and her spouse). Plan 1 covers all union employees and provides for a contribution of 10 percent of compensation. Union payroll totals \$1 million. Plan 2 covers the owner and her spouse, each of whom receive an annual salary of \$50,000. Total covered payroll is therefore \$1.1 million, 25 percent of which is \$275,000. The contribution to Plan 1 is \$100,000, that is, 10 percent of \$1 million, leaving \$175,000 available for Plan 2. A contribution of \$90,000 could be made to Plan 2, \$45,000 each for the husband and wife.

Compensation

The limitation on compensation is based on compensation paid during the employer's taxable year to the employees who, during such year, are "beneficiaries" of the funds accumulated under the plan.³ In Revenue Ruling 80-145 the Service confirmed that the definition of compensation in the plan is *not* relevant for purposes of the previously mentioned limits.

¹ IRC Section 404(a)(3)(A)(i)(I).

² IRC Section 404(a)(3)(a)(iv).

³ Treasury Regulation §1.404(a)-9(b).

Example. A calendar year employer maintains a calendar year profit sharing plan that uses a traditional dual entry system. Employees who enter the plan mid-year receive an allocation based only on their compensation earned while a participant in the plan. Nevertheless, for purposes of the 25 percent deduction limit, the individual's compensation for the full year is included.

Example. An employer maintains a plan which defines compensation for allocation purposes as "base" compensation, therefore *excluding* overtime and bonuses. For deduction purposes all compensation, *including* bonuses and overtime, is counted.

Compensation in excess of the IRC Section 401(a)(17) limit—\$225,000 for years beginning in 2007—may not be considered for purposes of the deductible limits.⁴ Additionally, compensation *includes* the following amounts not included in the employee's income:⁵

- Amounts not included in the employee's income under IRC Section 402(g)(3) pertaining to amounts contributed to 401(k) plans, 403(b) arrangements, salary reduction simplified employee pension plans (SARSEPs) and savings incentive match plan for employees (SIMPLE) plans;
- Amounts not included in the employee's income under IRC Section 125 pertaining to amounts contributed to cafeteria plans; and
- Amounts not included in the employee's income under IRC Section 132(f)(4) pertaining to amounts contributed to qualified transportation fringe benefit plans.

Benefiting Participants

As indicated above, both the code and the regulations limit the compensation that may be included to compensation paid to "beneficiaries under the plan." In Revenue Ruling 65-295 the Service held that where a profit-sharing plan provided that a terminating employee did not participate in the allocation of the contributions in the year of termination of employment, the compensation paid to the employee in such year was not included in the total compensation for purposes of determining the deduction limit.

The above rule seems relatively clear; if the employee is not receiving an allocation, their compensation may not be considered. The ruling, however, was issued long before the advent of 401(k) plans.

Many 401(k) plans provide for numerous types of contributions—profit sharing contributions, matching contributions, employee deferrals, etc. Where a profit sharing contribution is made to such a plan for a year, clearly the compensation of those participants receiving an allocation of such contribution may be considered.

But consider the employees not receiving a profit sharing allocation (for example, due to an end of the year employment requirement), but who elect to defer into the plan, and, in doing so, receive a matching contribution. Again, it would seem clear that such employees' compensation would be considered as they are receiving an allocation of employer contributions for the year.

It gets less clear when the employee receives no *employer* dollars. Possibly, the employee has made elective deferrals but the plan either does not provide for matching contributions, or the employee has not satisfied a condition to receive a match (such as end of the year employment). It would certainly appear that such a participant is a beneficiary of funds accumulated under the plan, albeit his or her own funds. Further guidance with respect to this issue is needed from the IRS (which has given some conflicting answers to this question in informal settings).

⁴ IRC Section 404(l).

⁵ IRC Section 404(a)(12).

Finally, what about employees who are eligible to defer, elect not to, and otherwise receive no allocations under the plan? Are such employees “beneficiaries” under the plan? Although logic might dictate they are not, they *are* considered benefiting under the plan for purposes of the minimum coverage rules of IRC Section 410(b). Again, definitive guidance from the IRS would be helpful in understanding this issue.

Elective Deferrals

Prior to the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), elective deferrals were considered part of the employer contribution when determining the maximum deductible amount. EGTRRA added IRC Section 404(n) which provides that post 2001 elective deferrals are not considered when determining the deductible limits under IRC Section 404(a)(3).

Additionally, EGTRRA added IRC Section 404(a)(12), noted previously, which provides that compensation includes elective deferrals when determining the deductible limits under IRC Section 404(a). Previously, only taxable compensation could be considered when determining the deductible limit.

Example. The only employees of Jane and John Doe, CPA, P.C. are Jane and John Doe. During 2007 Jane and John receive salaries of \$180,000 and \$56,000 respectively. Total compensation is therefore \$236,000, such that a deduction of up to \$59,000 (25 percent of \$236,000) may be taken for employer contributions made to the Jane and John Doe, CPA, P.C. 401(k) Profit Sharing Plan. Jane and John are both over age 50 such that they each may make elective deferrals of \$20,500 to the plan. For 2007 total allocations under the plan could be as follows:

	Compensation	401(k)	Profit Sharing	Total
Jane	\$180,000	\$20,500	\$29,500	\$ 50,000
John	56,000	20,500	29,500	50,000
Total	\$236,000	\$41,000	\$59,000	\$100,000

Different Plan Year and Tax Year

Recall from the previous text, that the 25 percent deduction limit is based on compensation paid during the employer's tax year. When the plan year and the tax year are not the same it is necessary to ensure that this limitation is met. (As discussed in more detail to follow, plan contributions are deductible in a tax-year if paid no later than the due date of the tax return, including extensions.)

Example. ABC Corporation, with a June 30 tax year, maintains a profit sharing plan with a December 31 year end. For the tax year ended June 30, 2007, participant payroll totaled \$600,000. ABC's profit sharing contribution for the 2006 plan year, contributed at such a time that it is deductible on the June 30, 2007 tax return, was \$100,000.

ABC extends its June 30, 2007 tax return to March 15, 2008. If deposited by this extended due date, \$50,000 of ABC's profit sharing contribution for the 2007 plan year could also be deducted on the June 30, 2007 tax return. [See, however, the following discussion regarding matching contributions pertaining to post tax-year end 401(k) contributions.]

Timing of Payments

IRC Section 404(a)(3) provides plan contributions are deductible “in the taxable year when paid”.⁶ Under IRC Section 404(a)(6) however, a taxpayer is deemed to have made a payment on the last day of the preceding taxable year if the payment is “on account of” such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions).

To take advantage of the grace period under IRC Section 404(a)(6) Revenue Ruling 76-28 imposes the following conditions:

- a. IRC Section 404(a)(6) applies whether the taxpayer is on the cash or accrual method of accounting, and whether or not the conditions for accrual otherwise generally required of accrual basis taxpayers have been met.⁷
- b. The plan must treat the payment in the same manner that a payment actually received on the last day of such preceding taxable year of the employer would be treated.
- c. One of the following conditions is satisfied:
 - (1) The employer designates the payment in writing to the plan administrator or trustee as a payment on account of the employer’s preceding taxable year, or
 - (2) The employer claims such payment as a deduction on his tax return for such preceding taxable year (or, in the case of a contribution by a partnership on behalf of a partner, the contribution is shown on schedule K of the partnership tax return for such year).

A payment may be designated as a payment on account of the preceding taxable year in the manner provided above at any time on or before the due date (including extensions) of the tax return for such year. Therefore, if the return was first filed without taking such a deduction, an amended return may be filed claiming the deduction as long as filed before the extended due date (or the original due date if no extension was obtained). However, once a payment has been designated or claimed on a return in the manner provided above as being on account of a preceding taxable year, the employer may not retract or change such designation or claim.

Example. Employer X, a calendar year taxpayer, maintains a profit sharing plan which also has a calendar year-end. Employer X’s 2006 tax return was extended to September 15, 2007. On June 15, 2007 X files its tax return claiming a deduction for a profit sharing contribution for its 2006 plan year, and makes the contribution shortly thereafter. While doing some 2007 tax planning in early September it is determined that the deduction would be better on the 2007 tax return. X may not amend its 2006 return and remove the profit sharing deduction.

Example. Assume instead that Employer X determined that it would not make a profit sharing contribution for 2006, and filed its 2006 tax return on June 15, 2007 claiming no deduction. In early September X decided that it would like to make a profit sharing contribution for 2006 after all. As long as the contribution is made and the amended return is filed by September 15, 2007, this is permissible.

⁶ Similar language is found in IRC Section 404(a)(1) pertaining to defined benefit plans.

⁷ In Field Service Advice 199922005 the IRS affirmed that the all events and economic performance tests of IRC Section 461 did not need to be met before deducting plan contributions.

It should be noted that Revenue Ruling 76-28 does *not* require a board resolution prior to the end of the tax-year (or at any time) in order for a contribution to be deductible. The noted requirements are the sole requirements.⁸

Additionally, if a company files its tax return prior to the original due date, but after obtaining an extension of time for filing, the due date under IRC Section 404(a)(6) is the extended due date.⁹ Conversely, an extension is *not* valid where the return is filed prior to the original due date and prior to filing for the extension.¹⁰ It is therefore not necessary to make a contribution prior to the filing of the tax return, only that it be made by the due date of such tax return (including valid extensions).

On the other hand, the plan must exist prior to the end of the year. In the case of *Engineered Timber Sales, Incorporated v. Commissioner*, 74 T.C. 808 (July 22, 1980) the tax court ruled that the plan and trust must be in existence and executed prior to the end of the employer's tax year in order for a deduction to be taken.

The IRS reiterated this in Revenue Ruling 81-114. The Service also ruled in 81-114 that if, under local law, a valid trust has been created by the end of the taxable year *except for the existence of corpus*, the trust will be deemed to be in effect if the corpus is furnished (that is, the plan is funded) no later than the due date (including extensions) of the employer's tax return. Accordingly, contrary to popular opinion, it is *not* necessary to open an account for the trust prior to the end of the tax year; it is simply necessary that the documents are properly executed.

Acceleration of 401(k) Deductions

Revenue Rulings 90-105 and 2002-46 dealt with an employer maintaining a calendar year 401(k) plan that provided for matching contributions, as set forth in the following example:

Example. Corporation M maintains Plan X, which includes a 401(k) arrangement providing for matching contributions. M's tax year ends June 30, and Plan X has a December 31 plan year. Plan X provides for M's Board of Directors to set a minimum contribution for a plan year, to be allocated first toward elective deferrals and matching contributions, with any excess to be allocated to participants as of the end of the plan year in proportion to compensation earned during the plan year. M's Board of Directors adopted a resolution on June 15, 2001, setting a minimum contribution of \$8 million for the 2001 calendar plan year. By December 31, 2001 (the last day of Plan X's 2001 calendar plan year), M had contributed \$8 million to Plan X. This amount consisted of (a) \$3.8 million for elective deferrals and matching contributions attributable to compensation earned by plan participants before the end of M's June 30, 2001 tax year (Pre-Year End Service Contributions), and (b) \$4.2 million for elective deferrals and matching contributions attributable to compensation earned by plan participants after the end of such tax year (Post-Year End Service Contributions). M made each contribution to Plan X at the same time that the related wages were paid.

M received an extension of time to March 15, 2002, to file the income tax return for its June 30, 2001 tax-year. On this return, M claimed a deduction for the entire \$8 million for elective deferrals and matching contributions made to Plan X during Plan X's 2001 calendar plan year. The total amount contributed and claimed by M as a deduction did not exceed percentage limitations of IRC Section 404(a)(3)(A)(i).

The Service pointed to the requirement under Rev. Rul. 76-28 that an amount deposited after the end of the tax year is deductible in the previous year only if the plan treats the deposit in the same manner that a

⁸ See also Private Letter Ruling 8010123.

⁹ Revenue Rulings 66-144 and 84-18.

¹⁰ Private Letter Ruling 8336006.

payment received on the last day of the corporation's tax-year is treated. The Service ruled that the plan could not have done so since compensation cannot be deferred and contributed to a plan as elective deferrals, and matching contributions cannot be made regarding those elective deferrals, until the underlying compensation has actually been earned. Accordingly, only the \$3.8 million dollars pertaining to the "Pre-Year End Service Contributions" was deductible on the June 30, 2001 tax return.

Carryover

Amounts paid in a taxable year in excess of the amount deductible under §404(a)(3) are deductible in succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year.¹¹

Defined Benefit Plans (Pre-2008)

A defined benefit plan is allowed a deduction based on one of the following amounts:

Minimum Funding

The amount necessary to satisfy the minimum funding standard of IRC Section §412(a) for the current year and any prior year if such amount is greater than the amount determined under the "level funding" or "normal cost plus limit adjustments," to follow.¹²

Pursuant to Treas. Reg. §1.404(a)-14(e), the amount deductible under IRC Section 404(a)(1)(A)(i) with respect to a plan year is the sum of (i) the amount required to satisfy the minimum funding standard of IRC Section 412(a) for the plan year (see Chapter 10), and (ii) an amount equal to the "includible employer contributions."

The term "includible employer contributions" means contributions which were required by IRC Section 412 for the immediately preceding plan year and which were not deductible under IRC Section 404(a) for the prior taxable year of the employer, *solely because* they were not contributed during the prior taxable year (determined with regard to §404(a)(6)).

Example. A calendar year taxpayer maintains a calendar year defined benefit plan. The minimum funding requirement for the year ended December 31, 2006 was \$50,000. The employer's 2006 tax return was *not* extended, and the contribution was made after March 15, 2007, but prior to September 15, 2007.¹³ Unless there is another reason the contribution could not be deducted in 2006, the \$50,000 is included in the amount deductible under IRC Section 404(a)(1)(A)(i) in 2007, along with the minimum funding required for 2007.

Example. Presume that the employer *did* extend its tax return. Presume further that the employer was in the 15 percent tax bracket in 2006 and the 36 percent bracket in 2007. Since the contribution was made in 2007, could the 2006 contribution be deducted in 2007 (and not in 2006) along with the 2007 contribution? No, since the contribution was made in a timely manner for deduction in 2006 it is not an "includible employer contribution."

Under IRC Section 412(c)(8), a plan amendment adopted up until 2½ months after the end of the plan year may be taken into account for purposes of determining the minimum funding requirement for the year.

¹¹ IRC Section 404(a)(3)(A)(ii).

¹² IRC Section 404(a)(1)(A)(i).

¹³ IRC Section 412(c)(10).

Example. A calendar year taxpayer maintains a defined benefit plan which is also on a calendar year. The minimum contribution for the 2006 plan year is \$100,000. On March 1, 2007 the accountant informs the taxpayer that they have a more serious tax problem than anticipated for 2006. The plan may be amended to increase the formula (and therefore the required funding) for 2006 as long as it is done no later than March 15, 2007.

Level Funding

The level funding amount is the amount necessary to provide with respect to all of the employees under the trust, the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee. If the unfunded cost with respect to any 3 individuals is more than 50 percent of the remaining unfunded cost, the unfunded cost attributable to such individuals must be distributed over at least 5 taxable years.¹⁴

This section does *not* serve to otherwise reduce the amount deductible as the minimum-funding amount above (a). In Private Letter Ruling 8210086, a new plan had two shareholder-participants who were reaching normal retirement age in four years. The plan's funding method was individual aggregate. The Service held that a four-year spread was required to meet the funding standard of IRC Section 412.¹⁵

Normal Cost Plus Limit Adjustments

Normal Cost Plus Limit Adjustments is defined as an amount equal to the normal cost of the plan, plus, if past service or other supplementary credits are provided, an amount necessary to amortize the unfunded costs attributable to such credits in equal annual payments (until fully amortized) over 10 years.¹⁶

Full Funding Limit

In no event may the deductible amount exceed the full funding limitation for such year determined under IRC Section 412.¹⁷

Unfunded Current Liability

Under IRC Section 404(a)(1)(D), the maximum amount deductible may not be less than the "unfunded current liability." Generally, the "current liability" is the present value of benefits earned to date under the plan (IRC Section 412(l)(7)(A)). For purposes of IRC Section 404(a)(1)(D), the unfunded current liability is generally 150 percent of the current liability less plan assets.

In making the above determination, plan amendments within the previous 2 years which increase benefits for Highly Compensated Employees (HCEs) may not be taken into account in the case of plans with fewer than 100 participants.¹⁸

There was a question as to how new plans were to be handled under this two-year rule. That is, could a new plan deduct 150% of its current liability from the beginning, or was the adoption of a plan considered an amendment for purposes of this two-year rule?

The IRS answered this question in Notice 2007-28, Q&A 5. The IRS determined that a new plan did NOT represent an amendment IF the employer did not maintain any other defined benefit plan covering any

¹⁴ IRC Section 404(a)(1)(A)(ii).

¹⁵ See also Private Letter Ruling 8349063.

¹⁶ IRC Section §404(a)(1)(A)(iii).

¹⁷ IRC Section, flush language, Treas. Reg. §1.404(a)-14(k).

¹⁸ IRC Section 404(a)(1)(D)(ii).

Highly Compensated Employees during the past two years. This effectively prevents an employer from adopting a new plan every year as a way around the 2-year rule. Accordingly, absent the existence of such a prior defined benefit plan, an employer may deduct 150% of its current liability in the first year of a plan.

Additionally, in measuring the present value of benefits, a specific range of interest rates (issued monthly by the IRS) must be used, and the use of a specific mortality table (updated from time to time by the IRS) is required.¹⁹

Terminating Plans

Generally contributions to terminating plans are subject to the general deduction limits of IRC Section 404(a). This can result in contributions that are required to fund termination benefits but that are not deductible. Such amounts are deducted ratably over the ten-year period following the year of termination.²⁰

IRC Section 404(g) allows a deduction for contributions to a terminating plan to the extent such contributions do not cause assets to exceed the amount guaranteed by the Pension Benefit Guaranty Corporation (PBGC). Additionally, PBGC covered plans may take a deduction in the year of termination for the amount needed to make the plan sufficient to pay all benefit liabilities, whether or not guaranteed.²¹

Carryover

Amounts paid in a taxable year in excess of the amount deductible under §404(a)(1) are deductible in succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year.²²

See Chapter 10, “Defined Benefit Plan Design,” for further discussion on the deduction rules for defined benefit plans including discussion of the determination of normal cost, the concept of amortization, and a general discussion of funding methods.

Plan Year Basis for Deduction

The deductible limit for defined benefit plans *applies* for an employer’s *taxable* year but is *determined* on the basis of the *plan* year. If such years coincide, then the deductible limit for the taxable year is the deductible limit for the plan year that coincides with that year. If the years do not coincide, the deductible limit, determined under the rules set forth previously, for a given taxable year of the employer, is one of three alternatives.

- a. The deductible limit determined for the plan year *beginning* within the taxable year;²³
- b. The deductible limit determined for the plan year *ending* within the taxable year;²⁴ or
- c. A weighted average of a. and b. based upon the number of months of each plan year falling within the taxable year.²⁵

The same alternative must be used for each taxable year unless consent to change is obtained under IRC Section 446(e).

¹⁹ IRC Section 412(l)(7)(C).

²⁰ Treas. Reg. §1.404(a)-6(b).

²¹ IRC Section 404(a)(1)(D)(iv).

²² IRC Section 404(a).

²³ Treas. Reg. §1.404(a)-14(c).

²⁴ Treas. Reg. §1.404(a)-14(c).

²⁵ Treas. Reg. §1.404(a)-14(c).

Defined Benefit Plans (Post-2008)

Pursuant to IRC Section 404(o), for tax years beginning after 2007, the maximum deductible contribution is the greater of (1) the contribution required under IRC Section 430 (see chapter 10), or (2) the sum of:

1. The Funding Target for the Plan Year;
2. The Target Normal Cost for the Plan Year; and
3. The Cushion Amount for the Plan Year.

The Funding Target is basically the present value of benefits earned under the plan as of the first day of the Plan Year, and the Target Normal Cost is the present value of benefits earned during the Plan Year (including increases due to average compensation increases). The terms are discussed in more detail in Chapter 10.

Pursuant to IRC Section 404(o)(3), the Cushion amount for the Plan Year is the sum of

1. 50 percent of the Funding Target, and
2. The amount by which the Funding Target would increase if the plan were to take into account increases in compensation which are expected to occur in future years. Except in the case of plans covered by PBGC, such projected increases may not recognize compensation in excess of the IRC Section 404(l) limit. Additionally, such projected increases may not cause the limitations of IRC Section 415(b) to be exceeded.

In determining the Cushion Amount, plan amendments within the previous 2 years which increase benefits for HCEs may not be taken into account in the case of plans with fewer than 100 participants.²⁶

Multiple Plans

IRC Section 404(a)(7) sets forth an additional set of limitations that could apply where an employer maintains one or more defined benefit plans and one or more defined contribution plans. Under IRC Section 404(a)(7)(A), the total amount deductible in a taxable year under such plans may not exceed the greater of:

- 25 percent of the compensation paid during the taxable year to the beneficiaries under the plans, or
- The amount of contributions made to the defined benefit plan(s) to the extent that such contributions do not exceed the amount necessary to satisfy the minimum funding standard with respect to the defined benefit plan(s) for the plan year which ends with or within such taxable year (or for any prior plan year).

These rules apply where both of the following exist:

- The employer contributes to both a defined benefit plan and a defined contribution plan for same tax year;²⁷ and
- At least one employee is a beneficiary under both plans²⁸

²⁶ IRC Section 404(o)(4).

²⁷ IRC Section 404(a)(7)(A).

Additionally, for tax years beginning after 2005, the Pension Protection Act of 2006 added IRC Section 404(a)(7)(C)(iii). This section provides that, in the case of employer contributions to one or more defined contribution plans, the 25% limit applies only to the extent that such contributions exceed 6 percent of the compensation paid during the taxable year to the beneficiaries of the defined contribution plans. In Notice 2007-28 the IRS concluded that the language of IRC Section 404(a)(7)(C)(iii) increases the limitation from 25% to 31% where contributions to the defined contribution plans exceed 6% of compensation. That is, per Q&A 8 of the Notice, the first 6% of contributions to defined contribution plans are effectively ignored when applying the 25% limit.²⁹

Further, for tax years beginning after 2007, if the defined benefit plan is covered by the PBGC, the limits do not apply.³⁰

In determining whether one or more employees is a beneficiary under both a defined benefit plan and a defined contribution plan, the rules under Revenue Ruling 65-295, discussed previously, serve as a starting point. That is, in order to be considered a beneficiary under the defined contribution plan, a current allocation must be made to the employee's account balance.

Example. Employer X maintains Plan A, a profit sharing plan covering all 10 of its employees. Beginning in 2007, Employer X amends the Plan A to preclude further allocations for 5 of the plan participants. These 5 participants will be participants in a newly formed defined benefit plan. The other 5 participants in Plan A will continue to receive profit sharing contributions under such plan and be excluded from participation in the defined benefit plan. Employer X's deduction for contributions to the two plans for 2007 will not be limited to 25 percent of compensation as no employee benefits under both plans in 2007.

If the situation in the example were reversed, it is likely the IRS would impose the limit.

That is, if a defined benefit plan is amended to freeze benefits for some participants, and such participants then receive contributions under a defined contribution plan, it is likely that the IRS would argue that such participant is a beneficiary under both plans. The logic here would be that funding of defined benefit plans is not simply done on a year to year basis. Rather, contributions made during a given year cover all liabilities under the plan: past, present, and to some extent, future.

Example. Employer X maintains Plan B, a defined plan covering all 10 of its employees. Beginning in 2007 Employer X amends Plan B to preclude further benefit accruals for 5 of the plan participants. These 5 participants will be participants in a newly formed profit sharing plan. The other 5 participants in Plan B will continue to earn benefit accruals under such plan, and be excluded from participation in the profit sharing plan. Employer X's deduction for contributions to the two plans for 2007 likely will be limited to 25 percent of compensation.

Let's now look at a set of examples applying the previously mentioned rules. Each of the examples provides for an allocation of contributions and an accrual of benefits that is non-discriminatory under the rules of IRC Section 401(a)(4) and the regulations thereunder. Our employee census is as follows:

²⁸ IRC Section 404(a)(7)(C)(i).

²⁹ IRC Section 404(a)(7)(C)(iii).

³⁰ IRC Section 404(a)(7)(C)(iv).

	Compensation	401(k)	Age
Owner physician	\$225,000	\$20,500	57
Employee physician	225,000	15,500	41
Staff 1	15,000	—	27
Staff 2	30,000	—	43
Staff 3	30,000	—	60
Staff 4	30,000	—	60
Staff 5	25,000	—	41
Staff 6	25,000	—	40
Total	\$605,000	\$36,000	

With a compensation total of \$605,000, the deduction limit is \$187,550 (31% of \$605,000) where the combined plan limit applies. Also, the combined plan limit will not apply where the total allocations to the defined contribution plan does not exceed \$36,300.

Note that for ease of illustration the staff employees are presumed not to elect to defer any of their own dollars into the 401(k) portion of the plan. If any of the staff decided to do so it would have no effect on the results.

The first scenario provides for the following:

- Safe harbor 401(k) plan utilizing the 3 percent non-elective contribution
- Additional profit sharing to (i) maximize Owner-physician, (ii) provide each staff employee participant a contribution of 7 percent of compensation, and (iii) provide Employee-physician a contribution of 2 percent of compensation
- The total of the safe harbor and profit sharing amounts is shown below in column headed "PS + SH"
- A cash balance defined benefit plan providing contribution credits of 60 percent of compensation, not to exceed \$125,000, for the Owner-physician, and 5 percent of compensation, not to exceed \$1,000, for the staff. The Employee-physician is excluded from participation in the defined benefit plan. (Amounts indicated in column headed "DB")

The results are as follows:

	PS + SH	DB	Total Employer	401(k)	Total
Owner-physician	\$29,500	\$125,000	\$154,500	\$20,500	\$175,000
Employee-physician	11,250	—	11,250	15,500	26,750
Staff 1	1,500	750	2,250	—	2,250
Staff 2	3,000	1,000	4,000	—	4,000
Staff 3	3,000	1,000	4,000	—	4,000
Staff 4	3,000	1,000	4,000	—	4,000

	PS + SH	DB	Total Employer	401(k)	Total
Staff 5	2,500	1,000	3,500	—	3,500
Staff 6	2,500	1,000	3,500	—	3,500
Total	\$56,250	\$130,750	\$187,000	\$36,000	\$223,000

Since employees participate in both plans, and since the employer contribution to the profit sharing plan exceeds 6 percent of compensation, the 25 percent limit applies but only to the extent that the contributions to the defined contribution plan exceed 6% of compensation. As previously indicated, such limit, including the first 6% to the defined contribution plan, is \$187,550 and is therefore met by the above.

The second scenario provides for the following:

- Safe harbor 401(k) plan utilizing the 3 percent non-elective contribution (to staff employees only)
- Additional profit sharing to provide (i) \$6,000 to Owner-physician, (ii) each staff employee participant a contribution of 9 percent of compensation, and (iii) Employee-physician a contribution of 2 percent of compensation
- A cash balance defined benefit plan providing contribution credits of 85 percent of compensation, not to exceed \$185,000, for the Owner-physician, and 5 percent of compensation, not to exceed \$1,000, for the staff. The Employee-physician is excluded from participation in the defined benefit plan.

The results are as follows:

	PS + SH	DB	Total Employer	401(k)	Total
Owner-physician	\$ 6,000	\$185,000	\$191,000	\$20,500	\$211,500
Employee-physician	10,000	—	10,000	15,500	25,500
Staff 1	1,800	750	2,550	—	2,550
Staff 2	3,600	1,000	4,600	—	4,600
Staff 3	3,600	1,000	4,600	—	4,600
Staff 4	3,600	1,000	4,600	—	4,600
Staff 5	3,000	1,000	4,000	—	4,000
Staff 6	3,000	1,000	4,000	—	4,000
Total	\$34,600	\$190,750	\$225,350	\$36,000	\$180,925

Since the employer contribution to the profit sharing plan does not exceed 6% of compensation, the IRC Section 404(a)(7) 25% limit does not apply. However, in Notice 2007-28 the IRS determined that the limits of IRC Section 404(a)(7) DO apply to the contributions to the defined benefit plan. Therefore, per Q&A 9 of the Notice, the deductible limit to the defined benefit is the greater of:

- 25 percent of the compensation paid during the taxable year to the beneficiaries under the plans, or
- the amount of contributions made to the defined benefit plan(s) to the extent such contributions do not exceed the amount necessary to satisfy the minimum funding standard with respect to the defined benefit plan(s) for the plan year which ends with or within such taxable year (or for any prior plan year).

In the above example the \$190,750 is presumed to be the minimum required contribution to the defined benefit plan.

Self-Employed Persons

IRC Section 404(a)(8)(C) limits the deduction on behalf of a self-employed person to such person's earned income (determined before plan contributions) from the trade or business establishing the plan. This limitation precludes a deduction in the case of the minimum funding required for a defined benefit plan to the extent such minimum funding exceeds such earned income.

Example. X has practiced as a physical therapist for 3 years as a sole proprietor. She has maintained no qualified plan and has an average earned income over the period of \$50,000. In her fourth year, X adopts a defined benefit plan, which calls for a benefit of 100 percent of average pay, based on all years of service. Assume a level cost funding method calls for a \$40,000 annual contribution. If in year 4, or some later year, X has earned income of less than \$40,000, the entire contribution may not be deductible.

Under IRC Section 401(c)(2), the term "earned income" means the net earnings from self-employment³¹, but such net earnings are determined:

- Only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor.³²
- With regard to the deductions for qualified plans or simplified employee pension plans (SEPs) for the self employed person and their common law employees.³³
- With regard to the deduction for ½ the self employment tax allowed to self employed persons by IRC Section 164(f) (NOT the "in lieu of" deduction allowed by IRC Section 1402(a)(12)).³⁴

Expenses and Fees

Expenses incurred by the employer in connection with establishing or maintaining a plan, such as trustee's and actuary's fees, are deductible by the employer under IRC Section 162 to the extent that they are ordinary and necessary.³⁵ Expenses are only deductible outside the IRC Section 404 limits if paid directly by the employer, that is, not as a reimbursement to the plan for expenses previously paid by the plan. Additionally,

³¹ As defined in IRC Section 1402(a).

³² IRC Section 401(c)(2)(A)(i).

³³ IRC Section 401(c)(2)(A)(v).

³⁴ IRC Section 401(c)(2)(A)(vi).

³⁵ Treas. Reg. §1.404(a)-3(d).

brokerage commissions are not deductible outside the limits of IRC Section 404 even if paid directly by the employer.³⁶

Investment management fees paid by the employer on behalf of the plan are deductible by the employer under IRC Section 162.³⁷ A wrap fee of 2½ percent of plan assets was allowed as a deduction outside of the IRC Section 404 limits where it was billed to and paid directly by the employer. The fee was unaffected by the number or volume of transactions, and was found not to be part of the cost of the assets purchased. As intimated previously, such fees must be paid directly by the employer and not as a reimbursement to the account.

Non-Deductible Contributions

IRC Section 4972 imposes a penalty tax³⁸ on the employer equal to 10 percent on “nondeductible contributions.” Pursuant to IRC Section 4972(c) (and the instructions to Form 5330), the term “nondeductible contributions” means the sum of:

- The excess (if any) of the amount contributed by the employer during the taxable year over the amount allowable as a deduction under IRC Section 404, plus
- The excess for the preceding taxable year reduced by the sum of:
 - The portion of such previous year excess returned to the employer during the current taxable year, and
 - The portion of such previous year excess deductible under IRC Section 404 for the current year.

In determining the amount deductible under IRC Section 404 for the current year, carryover contributions are deducted before current year contributions.³⁹

The tax is not imposed on a self employed person to the extent that the required contribution to such person’s defined benefit plan exceeds earned income [and therefore is not deductible pursuant to IRC Section 404(a)(8)(C)].⁴⁰

Pursuant to IRC Section 4972(c)(6), contributions to one or more defined contribution plans that are not deductible because they exceed the combined plan limits of IRC Section 404(a)(7) are not subject to the tax to the extent that they do not exceed employer matching contributions made to a 401(k) plan.

³⁶ Revenue Ruling 86-142.

³⁷ See Private Letter Ruling 9252029.

³⁸ Reported on Form 5330.

³⁹ IRC Section 4972(c)(2).

⁴⁰ IRC Section 4972(c)(4).

Chapter 13

Plan Correction Programs— EPCRS, VFCP, and DFVC

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The Internal Revenue Service's (IRS's) Employee Plans Compliance Resolution System (EPCRS) and the Department of Labor's (DOL's) Voluntary Fiduciary Correction Program (VFCP) are discussed in this chapter. The EPCRS is a comprehensive system of integrated correction programs that plan sponsors may use to correct eligible failures and to continue providing their employees with retirement benefits on a tax-favored basis. The VFCP allows certain persons to avoid potential civil actions, penalties, and the assessment of civil penalties under the Employee Retirement Income Security Act of 1974 (ERISA). In general, the exemption affects plans, participants, and beneficiaries of such plans in connection with investigation or civil action by the DOL.

Achieving a good result under the EPCRS and VFCP requires that plan sponsors and their advisers thoroughly understand all of the correction principles available and how those principles can best be applied under various facts and circumstances. Care must also be taken in determining whether a plan defect or multiple plan defects would be treated as significant or insignificant by the IRS under the EPCRS. Competing and sometimes conflicting correction principles may provide one solution that is better than another solution.¹

The Delinquent Filer Voluntary Compliance Program (DFVC), designed to encourage voluntary compliance with the annual reporting requirements under ERISA, is also discussed in this chapter.

¹ C. Frederick Reish, Bruce Ashton, and Nicholas J. White, *Journal of Taxation* (September 2003).

Employee Plans Compliance Resolution System

Compliance Qualification Failures

A *compliance qualification failure* is any failure that adversely affects the tax-sanctioned status of a qualified plan,² a Section 403(b) plan, a simplified employee pension plan (SEP), or a savings incentive match plan (SIMPLE-IRA) of an employer. Employee plans compliance resolution system (EPCRS) collectively refers to all of these types of plans—qualified, Section 403(b), SEP and SIMPLE-IRA—as “retirement plans,” and specifically states that successful completion of EPCRS correction procedures will result in a plan being treated as satisfying qualification requirements of the Internal Revenue Code (Code or IRC) as well as qualification requirements for purposes of the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes.³ The four types of compliance qualification failures under EPCRS are:

1. *Plan Document Failure.* A provision (or the absence of a provision) within the plan's written document that, on its face, violates Internal Revenue Code (IRC or the Code) provisions.⁴
2. *Operational Failure.* A problem (other than an employer eligibility failure) that arises solely from a failure to follow plan provisions (Failure to follow the terms of a plan providing for the satisfaction of nondiscrimination requirements of IRC Sections 401(k) and 401(m) is generally treated as an operational failure except to the extent the plan can be amended retroactively or, if amended, the provisions of the amendment were not followed).⁵
3. *Demographic Failure.* A violation of the nondiscrimination and/or the participation and coverage requirements that is not an operational or employer eligibility failure (Generally, a corrective amendment adding more benefits or increasing existing benefits is required to correct a demographic failure).⁶
4. *Employer Eligibility Failure.* The adoption of a plan by any ineligible employer, e.g., salary-reduction or elective simplified employee pension plan (SARSEP) adopted by a tax-exempt organization or a savings incentive match plan for employees, SIMPLE IRA plan adopted by an employer that is making contributions to a profit-sharing plan for its nonunion employees (An employer eligibility failure is not a plan document, operational, or demographic failure).⁷

Generally, none of the correction programs are available to correct failures that can be corrected under the Code and related regulations.⁸ In addition, excise and additional taxes will apply to corrections made under EPCRS, with the exception of certain corrections made under the Voluntary Correction With Service Approval Program (VCP), and Audit CAP.⁹

² A *qualified plan* is a plan that satisfies the requirements of IRC 401(a). Qualified plans include defined benefit plans, profit-sharing plans, money-purchase pension plans, IRC Section 401 (k) plans, and stock bonus plans, including employee stock ownership plans (ESOPs). Under EPCRS, a defect in a qualified plan is referred to as a *qualification failure*, which is any operational or form problem that adversely affects the qualification of a plan. See Rev. Proc. 2006-27, Section 5.01(2), 2006-22 IRB 945.

³ See Rev. Proc. 2006-27, Section 3.01, 2006-22 IRB 945.

⁴ Rev. Proc. 2006-27, Sections 5.01(2)(a), 5.04, 5.05, 2006-22 IRB 945; See, general requirements at IRC Sections 401(a) for qualified plans, e.g., 403(a), for qualified annuity plans, 408(k) for SEPs, and 408(p) for SIMPLE-IRA plans.

⁵ IRC Section 401(b); Rec. Proc. 2006-27, Sections 5.01(2)(b), 5.04, 5.05, 2006-22 IRB 945.

⁶ Rev. Proc. 2006-27, Sections 5.01(2)(c), 5.04, 5.05, 2006-22 IRB 945; See, requirements at IRC Sections 401(a)(4), 401(a)(26), 408(k), 408(p) or 410(b).

⁷ Rev. Proc. 2006-27, Section 5.01(2)(d), 2006-22 IRB 945.

⁸ Rev. Proc. 2006-27, Section 6.08, 2006-22 IRB 945.

⁹ Rev. Proc. 2006-27, Section 6.09, 2006-22 IRB 945.

With respect to SEP and SARSEP, the following qualification failures are mentioned:¹⁰

- Failure to satisfy the 125-percent deferral percentage test in a SARSEP
- Undercontributions to a SEP or SIMPLE IRA
- Failure to satisfy the 50-percent participation rate requirement for a SARSEP
- Failure to satisfy the 25-employee limitation for a SARSEP

Operational SEP and SIMPLE IRA failures corrected under The Self-Correction Program (SCP) are only available for insignificant failures.¹¹ Employer eligibility failures may also be corrected under the Voluntary Correction With Service Approval Program (VCP).

EPCRS programs are not open to 457(b) plans. However, the IRS will accept submissions relating to a Section 457(b) eligible government plan on a provisional basis outside of EPCRS through standards that are similar to EPCRS. No correction program is available for nongovernmental Section 457(b) plans.¹²

EPCRS is available on a limited basis to terminated plans and Orphan Plans, which are plans whose sponsor no longer exists, cannot be located, or has abandoned the plan.¹³ Specifically, qualification failures in a terminated plan may be corrected under VCP and Audit CAP, whether or not the plan trust is still in existence. An Orphan Plan that is terminating may be corrected under VCP and Audit CAP, provided that the party acting on behalf of the plan is an “Eligible Party”; that is, a court appointed representative with authority to terminate the plan and dispose of the plan’s assets.¹⁴

Correction Programs

Under EPCRS, the IRS provides three programs that are available for solving a compliance qualification failure.¹⁵ The programs are referred to as:

1. The Self-Correction Program (SCP)
2. The Voluntary Correction With Service Approval Program (VCP)
3. The Correction on Audit Program (Audit CAP)

Employers may not use the SCP for eligibility failures; SCP is not available to correct egregious failures. Egregious failures (and employer eligibility failures) can be corrected under VCP.¹⁶

The SCP is available if the plan is being audited by the IRS; but, in general, it can be used only to correct insignificant operational failures once the plan is being audited by the IRS.¹⁷

¹⁰ Rev. Proc. 2006-27, Section 6.10(3)-(5), 2006-22 IRB 945.

¹¹ Rev. Proc. 2006-27, Section 1.03, 2006-22 IRB 945.

¹² Rev. Proc. 2006-27, Section 4.10, 2006-22 IRB 945.

¹³ Rev. Proc. 2006-27, Sections 4.08, 4.09; 5.06(1), 2006-22 IRB 945. Note, however, that the term “Orphan Plan” does not include any plan terminated pursuant to Department of Labor regulations governing the termination of abandoned individual account plans.

¹⁴ Rev. Proc. 2006-27, Sections 4.08, 4.09; 5.06(2)(a), 2006-22 IRB 945. Note, however, that if the Orphan Plan is under investigation by the Department of Labor, an “Eligible Party” may be any person or entity who the Department has determined to have accepted responsibility for terminating the plan and distributing the plan’s assets.

¹⁵ Rev. Proc. 2006-27, Section 1.03, 2006-22 IRB 945.

¹⁶ Rev. Proc. 2006-27, Section 4.11, 2006-22 IRB 945.

¹⁷ Rev. Proc. 2006-27, Section 4.02, 2006-22 IRB 945.

Example. Scrooge Company has consistently covered only highly compensated employees (HCEs) under its plan. Alpha company has made contributions for the HCEs over the IRC Section 415 limit. Both Scrooge and Alpha have committed an egregious failure that can be corrected under VCP.

SCP, VCP, and Audit CAP are not available for qualification failures relating to the diversion or misuse of plan assets.¹⁸ Moreover, since significant failures for SEP and SIMPLE IRA plans cannot be corrected under the SCP, an employer must use the VCP or Audit CAP to correct a significant failure.¹⁹

Effective September 1, 2006, SCP is not available to correct any operational failure that is directly or indirectly related to an abusive tax avoidance transaction (ATAT).²⁰ Whether such matters may be addressed through VCP or Audit CAP will depend upon the extent to which the operational failures relate to the ATAT.²¹

Correction Principles

Generally, under EPCRS, a qualification failure is not considered corrected unless full correction is made with respect to all participants and beneficiaries and for all taxable years, including taxable years that are closed.²²

In determining whether full correction is accomplished, a plan must use a correction method that is reasonable and appropriate and that restores the plan to the position that it would have been in had the qualification failure not occurred. Restoring the plan to this position also means the restoration of current and former participants and beneficiaries to the benefits and rights they would have had if the qualification failure had not occurred.²³ Whether a particular correction method is reasonable and appropriate should be determined taking into account relevant facts and circumstances and the following principles:²⁴

- The correction method should, to the extent possible, resemble one already provided for in the IRC, regulations thereunder, or other guidance of general applicability.
- The correction method for a qualification failure relating to nondiscrimination should provide benefits to nonhighly compensated employees (NHCEs).
- The correction method should keep assets in the plan except to the extent the law permits corrective distributions to participants or beneficiaries or the return of assets to the employer.
- The correction method should not violate any other qualification requirement.

If more than one correction method is available to correct a particular type of operational failure, the correction method should be applied consistently in correcting all operational failures of that type for that plan year. For group submissions, the consistency requirement applies on a plan-by-plan basis.²⁵

Exceptions to Full Correction

Full correction is not required, however, in certain situations because it is unreasonable and not feasible. For example, reasonable estimates of benefits are allowed if it is not possible to make a precise calculation or if

¹⁸ Rev. Proc. 2006-27, Section 4.12, 2006-22 IRB 945.

¹⁹ Rev. Proc. 2006-27, Section 7, 2006-22 IRB 945.

²⁰ Rev. Proc. 2006-27, Section 4.13(1)(a), 2006-22 IRB 945

²¹ Rev. Proc. 2006-27, Section 4.13(1)(b)-(c), 2006-22 IRB 945

²² Rev. Proc. 2006-27, Section 6.02, 2006-22 IRB 945.

²³ Rev. Proc. 2006-27, Section 6.02(1), 2006-22 IRB 945.

²⁴ Rev. Proc. 2006-27, Section 6.02(2), 2006-22 IRB 945.

²⁵ Rev. Proc. 2006-27, Section 6.02(3), 2006-22 IRB 945.

the probable difference between the approximate and precise amount of benefits is insignificant and the administrative cost of determining the precise amount of benefits would significantly exceed that difference. The method must not discriminate significantly in favor of HCEs. Corrective distributions are not required if the participant or beneficiary cannot be located. Corrective distribution of benefits of \$50 or less is not required if the cost of processing and delivering the distribution exceeds the amount of the distribution.²⁶ In addition, the employer is not required to seek the return of an overpayment to a participant or beneficiary if the overpayment is \$100 or less,²⁷ nor is a plan sponsor required to distribute or forfeit “Excess Amounts” (as defined in Section 5.01(3) of the Revenue Procedure) when the Excess Amount is \$100 or less. However, if the Excess Amount exceeds a statutory limit, the plan sponsor must notify the participant or beneficiary that the Excess Amount, including earnings, is not eligible for a tax-free rollover.²⁸

The IRS may also waive full correction in certain instances involving a terminating Orphan Plan.²⁹

Corrective Allocation Principles

The following principles apply in determining corrective allocations and distributions:³⁰

- Corrective allocations should be based on the terms of the plan in effect at the time of failure and should be adjusted for earnings (or losses and forfeitures) that would have been allocated but for the failure. Adjustments for losses are not required.
- A corrective allocation of contributions, forfeitures, or both is considered an annual addition under IRC Section 415 for the limitation year to which the corrective allocation relates. However, the normal rules under IRC Section 404(j) prohibiting allowable deductions from exceeding IRC Section 415 limits apply.³¹
- Corrective allocations should come from employer contributions but may come from forfeitures if the plan permits the use of forfeitures to reduce employer contributions.

The Self-Correction Program

Except for insignificant defects that are detected during an IRS audit, the SCP is designed to be initiated by the plan sponsor or the plan administrator, without IRS involvement, with respect to any plan eligible for SCP.³² No sanctions or penalties are payable to the IRS in connection with use of SCP. The only cost to the plan sponsor is the cost of correcting the defect. A correction of a failure identified on audit requires IRS approval and the payment of a negotiated sanction. Self-correction only applies to insignificant operational failures in a retirement plan of an employer even if the failures are discovered by an agent upon examination of the plan or plan sponsor.³³

SCP is designed to cover qualification defects that arise from the failure to operate a plan in accordance with its terms. SCP is not available to cure qualification issues arising from defects in the plan document, e.g., a failure to amend for the Tax Reform Act of 1986 (TRA 86). It is also not available for qualification issues that arise because of a shift in demographics, e.g., a problem with the minimum coverage rules under

²⁶ Rev. Proc. 2006-27, Section 6.02(5)(b), 2006-22 IRB 945.

²⁷ Rev. Proc. 2006-27, Section 6.02(5)(c), 2006-22 IRB 945.

²⁸ Rev. Proc. 2006-27, Section 6.02(5)(e), 2006-22 IRB 945

²⁹ Rev. Proc. 2006-27, Sections 5.06(1), 6.02(5)(f), 2006-22 IRB 945

³⁰ Rev. Proc. 2006-27, Section 6.02(4), 2006-22 IRB 945.

³¹ IRC Section 404(j)(1).

³² Rev. Proc. 2006-27, Section 7, 2006-22 IRB 945.

³³ Rev. Proc. 2006-27, Sections 7, 8.01, 2006-22 IRB 945.

IRC Section 410(b). Finally, SCP cannot be used to correct operational failures that are egregious or that relate to the diversion of assets.³⁴

Under the SCP, operational defects must generally be corrected by the end of the second plan year following the plan year in which the defect arose. Significant operational defects relating to assets transferred to a plan in connection with a merger or acquisition can be corrected up to the last day of the plan year following the plan year in which the merger or acquisition occurs. Failures treated as insignificant can be corrected after these deadlines.³⁵

Example. Titanium Company sponsors a 401(k) plan with a plan year ending December 31. Titanium did not make a required top-heavy minimum contribution for the 2005 plan year. In addition, the plan failed to satisfy the ADP test. These failures are discovered in March 2007. Assuming Titanium otherwise satisfies the eligibility requirements for SCP, it has until the end of 2007 to correct the missing top-heavy minimum contribution. Correction of the failed ADP test could wait until December 31, 2008, as the two-year correction period is considered to begin one year after the plan year of failure.³⁶

Under SCP, a plan sponsor may correct an operational failure by a plan amendment to conform the terms of the plan to the plan's prior operations, but only to correct a limited category of operational failures listed in Section 2.07 of Appendix B to Revenue Procedure 2006-27, including plan amendments to retroactively add hardship distribution and plan loan features after such distributions or loans have occurred. Plan amendment under SCP may also be used to correct operational failures due to the early inclusion of otherwise eligible employees.³⁷ Plan sponsors making such amendments must submit an application for a determination letter on the amended plan before the end of the applicable remedial amendment period or cycle. The application must identify the plan amendment under SPC as such.³⁸ Self-correction by plan amendment is not otherwise available, even to correct so-called "scrivener's errors."

Significant or Insignificant

The factors to be considered in determining whether or not an operational failure is insignificant include but are not limited to the following:

1. Whether other failures occurred during the period being examined
2. The percentage of plan assets and contributions involved in the failure
3. The number of years the failure occurred
4. The number of participants affected versus the total number of participants
5. The number of participants affected versus the total number of participants that could have been affected
6. Whether correction was made within a reasonable time after the failure's discovery
7. The reason for the failure

³⁴ Rev. Proc. 2006-27, Section 4.01(1), 2006-22 IRB 945.

³⁵ Rev. Proc. 2006-27, Sections 8.01 and 9.02, 2006-22 IRB 945.

³⁶ Rev. Proc. 2006-27, Section 9.02, 2006-22 IRB 945.

³⁷ Rev. Proc. 2006-27, Section 4.05(2), Appendix B, Section 2.07, 2006-22 IRB 945.

³⁸ Rev. Proc. 2006-27, Section 4.06(2), 2006-22 IRB 945.

No single factor is determinative and the factors listed in the above as items 2, 4, and 5 should not be interpreted to exclude small business owners.³⁹

Favorable Letter Requirement

In order to correct significant operational failures (but not insignificant failures), the plan must have a favorable IRS letter. A favorable IRS letter is, in the case of an individually designed plan, a current favorable determination letter. Adopters of master or prototype plans and volume submitter plans will be considered to have favorable letters if the sponsors of these plans have received current favorable opinion or advisory letters. In the case of a SEP or SIMPLE IRA plan, the plan document must be a valid IRS approved model or prototype plan regardless of whether the operational failure is significant or insignificant.⁴⁰

Established Practices and Procedures

Before SCP can be used to correct an operational failure, the plan must have had established practices and procedures (whether formal or informal) that were reasonably designed to promote and facilitate overall compliance. Operational violations must have occurred because of an oversight or mistake in applying them or because the procedures that were in place, while reasonable, were not sufficient to prevent the failure from happening.⁴¹

Anonymous Submission Procedure

The IRS has established a procedure called the Anonymous (John Doe) Submission Procedure that permits any failure to be addressed without identifying the plan or its sponsor.⁴² A plan is not eligible to submit under the anonymous submission procedure if the plan or the plan sponsor is under examination. Payment of the appropriate VCP fee is required upon submitting a request under the anonymous submission procedure, however if the IRS and the plan sponsor fail to reach resolution, the IRS will refund 50 percent of the applicable VCP fee to the plan sponsor.⁴³

A submission under the anonymous submission procedure does not preclude or impede an examination of the plan sponsor or the plan before the date on which identifying information is provided to the IRS.⁴⁴

Safe-Harbors

Correction methods described in Appendixes A and B of Revenue Procedure 2006-27 are generally viewed as safe-harbor methods that may be used to resolve eligible operational failures through VCP.

Group Submission Procedures

A group submission procedure enables an eligible organization to address systemic operational and plan document errors that affect at least 20 client plans. An eligible organization includes a sponsor of a prototype plan or an organization that provides administrative services with respect to qualified plans, 403(b) plans, SEPs or SIMPLE IRAs.⁴⁵

³⁹ Rev. Proc. 2006-27, Section 8.02, 2006-22 IRB 945

⁴⁰ Rev. Proc. 2006-27, Section 4.03, 2006-22 IRB 945.

⁴¹ Rev. Proc. 2006-27, Section 4.04, 2006-22 IRB 945.

⁴² See, Rev. Proc. 2006-27, Section 10.10, 2006-22 IRB 945.

⁴³ See, Rev. Proc. 2006-27, Section 10.07(7), 2006-22 IRB 945.

⁴⁴ See, Rev. Proc. 2006-27, Section 10.10(2), 2006-22 IRB 945.

⁴⁵ See, Rev. Proc. 2006-27, Section 10.11.2, 2006-22 IRB 945.

Voluntary Correction With Service Approval Program

The VCP is designed to cover all types of qualification defects, namely, operational, plan document, and demographic. VCP is not available, however, to cure any violations of the exclusive benefit rule (e.g., misuse or diversion of plan assets).⁴⁶ Although there is no deadline, VCP is not available if the plan is being audited by the IRS.⁴⁷ Unlike SCP, established practices and procedures are not required to be in effect in order to utilize VCP.⁴⁸

Under VCP, a plan sponsor may correct an operational failure by amending a plan to conform the terms of the plan to the plan's prior operations, provided that the amendment complies with the requirements of 401(a), including nondiscrimination and minimum coverage requirements, and so long as the amendment does not eliminate any vested rights or benefits under the plan.⁴⁹ In addition, a plan sponsor may correct an operational failure by plan amendment to amend the plan to the extent necessary to reflect the corrective action; for example, amending to provide for qualified non-elective contributions when this type of contribution is necessary to correct an operational defect.⁵⁰ A favorable IRS letter is not required to take advantage of VCP.⁵¹

Procedures

The plan sponsor initiates the program by preparing an application to the IRS that contains all the relevant information.⁵² Essentially, the plan sponsor must describe the defect and the correction and explain why the problem will not recur. The Revenue Procedure contains a detailed submission assembly procedure to assist applicants in this task.⁵³

The IRS will respond to a VCP application with a compliance statement that addresses the failure and the terms of its correction and that contains the IRS's agreement not to disqualify the plan⁵⁴ on account of the operational failure described in the compliance statement. Within 30 days after the statement is issued, a plan sponsor that agrees with the statement must send a signed acknowledgment letter to the IRS. If this acknowledgment is made, the plan sponsor has 150 days after the issuance of the compliance statement to correct the operational failure.

The VCP generally will not provide the plan sponsor with relief from any excise taxes. There are three exceptions to this rule, however, such that otherwise applicable excise taxes will be waived under VCP in the following circumstances:

- Failure to satisfy the IRC Section 401(a)(9) minimum distribution rules;

⁴⁶ Rev. Proc. 2006-27, Section 4.12, 2006-22 IRB 945.

⁴⁷ Rev. Proc. 2006-27, Section 4.02, 2006-22 IRB 945. The actual term is "under investigation."

⁴⁸ Rev. Proc. 2006-27, Section 4.04, 2006-22 IRB 945.

⁴⁹ Rev. Proc. 2006-27, Section 4.05, 2006-22 IRB 945.

⁵⁰ Rev. Proc. 2006-27, Section 4.05, 2006-22 IRB 945.

⁵¹ Rev. Proc. 2006-27, Section 4.03, 2006-22 IRB 945.

⁵² Rev. Proc. 2006-27, Section 11, 2006-22 IRB 945.

⁵³ Rev. Proc. 2006-27, Section 11.14, 2006-22 IRB 945.

⁵⁴ Plan disqualification results in (a) under IRC Section 404(e)(5), the plan sponsor loses its deduction for contributions to the plan during the open tax years under the statute of limitations to the extent the contribution is not vested for the plan participants; (b) for a defined benefit plan, plan disqualification results in a total loss of the deduction (other than for a one-person plan), see Treas. Reg. 1.404(a)-12(b); (c) for tax years still open under the statute of limitations, the employee recognizes as income the vested portion of his or her plan benefit, see IRC Sections 402(b), 6501; (d) for tax years still open under the applicable statute of limitations, the plan's related trust recognizes any earnings as income for income tax purposes, see IRC Section 501 (a); and (e) distributions become ineligible for special tax treatment and cannot be rolled over on a tax-deferred basis (e.g., any amounts rolled over to an IRA or another qualified plan would not be excluded from income by reason of the rollover), see IRC Section 402(d).

- A corrective contribution that is nondeductible because it exceeds the deductible limit for the year of correction; or
- “Late” distribution of excess contributions or excess aggregate contributions where initial ADP (average deferral percentage and/or ACP (actual contribution percentage) testing was timely but was based on inaccurate data.

In each such instance, the plan sponsor must request a waiver of excise taxes in its VCP submission and provide an explanation supporting its request.⁵⁵ Nor is there any relief from the fiduciary conduct provisions under ERISA’s Title I, if applicable, although EPCRS makes express reference to the availability of the DOL “Voluntary Fiduciary Correction Program,” and the DOL’s “Delinquent Filer Voluntary Compliance Program,” both of which are discussed later in this chapter. These factors must be considered in reviewing the decision to use VCP and in analyzing the costs involved.

Correction on Audit Program

Audit CAP is available to a plan sponsor if the qualification defect (other than an insignificant operational error that can be handled through SCP) is discovered by the IRS during an audit. All defects that may be corrected under VCP may also be corrected under Audit CAP. If the plan sponsor corrects the qualification failures identified by the IRS, pays a sanction, and enters into a closing agreement with the IRS, then the IRS will not disqualify the plan on account of the qualification defect.⁵⁶

The amount of the sanction is a negotiated percentage of the full amount of the tax liability that would be due the IRS if the plan were disqualified for the years open under the statute of limitations (known as the *maximum payment amount*). The maximum payment amount will include taxes based on the loss of the employer’s deduction for plan contributions, taxes on trust earnings, taxes on individual employees for inclusion of plan contributions in their taxable compensation (including taxes on plan distributions that have been rolled over to other qualified trusts (as defined in Section 402(c)(8)(A)) or eligible retirement plans (as defined in Section 408(c)(8)(B)), and any penalties and interest that would accrue on any of these amounts.⁵⁷ The negotiated percentage is to bear a reasonable relationship to the nature, extent, and severity of the failures and must not be excessive.⁵⁸

EPCRS for SEP and SIMPLE IRA

Generally, the correction used for a SEP or SIMPLE IRA may either be similar to the correction method required for a qualified plan or 403(b) with a similar qualification failure, or a specific correction method listed for SEP or SIMPLE Plans.⁵⁹

Under the VCP, if a correction method that applies to a qualified plan is not feasible for a SEP or the IRS determines such method is not feasible, the IRS may provide a different correction method. Many of the correction methods do not address the employer’s lack of control over the accounts established by employees that are used to receive the SEP or SIMPLE IRA contributions.

⁵⁵ Rev. Proc. 2006-27, Section 6.09. Excise tax relief due to failure to satisfy the minimum required distribution rule is also available under Audit CAP.

⁵⁶ Rev. Proc. 2006-27, Section 13, 2006-22 IRB 945.

⁵⁷ Rev. Proc. 2006-27, Section 5.01(5), 2006-22 IRB 945. “Maximum payment amount” is defined for purposes of Section 403(b) corrections at Rev. Proc. 2006-27, Section 5.02(4).

⁵⁸ See Rev. Proc. 2006-27, Section 14.02 (2006-22 IRB 945) contains examples of factors taken into account in arriving at the negotiated percentage.

⁵⁹ See Rev. Proc. 2006-27, Section 4.05, 2006-22 IRB 945.

The Revenue Procedure lists the following failures as being included in failures that may need a different correction:

1. Failures relating to IRC Section 402(g), 415, or 401(a)(17)
2. Failures relating to deferral percentages
3. Discontinuance of contributions to a SARSEP
4. Retention of overcontributions for situations in which there was no violation of a statutory provision.⁶⁰

Excess Amount

For purposes of the EPCRS, excess amount means one of the following:

1. An overpayment
2. An elective deferral returned to satisfy IRC Section 415
3. An elective deferral in excess of the IRC Section 402(g) limit
4. An elective deferral that is distributed to satisfy IRC Section 401(a)(17) (the compensation limit)
5. An amount contributed on behalf of an employee that is in excess of the employee's SEP benefit
6. An excess contribution that is distributed to satisfy IRC Section 408(k)(6)(A)(iii)
7. Any similar amount required to be distributed in order to maintain plan qualification.⁶¹

Overpayment

An overpayment under a SEP or SIMPLE IRA is a distribution to an employee or beneficiary that exceeds the employee's or beneficiary's benefit under the terms of the SEP or SIMPLE IRA because of a failure to comply with the compensation limit under IRC Section 401(a)(17) or the annual additions limit of the lesser of 25 percent of the participant's taxable compensation or \$45,000 (\$50,000 with catch-up contribution for participants over age 50) under IRC Section 415 for 2007 or a payment to a SIMPLE IRA in excess of the employer's contribution maximum. An overpayment generally does not include a distribution of an excess amount.⁶²

Earnings

If a corrective allocation is made, it should be adjusted for earnings that would have been allocated to the participant's account if the violation had not occurred. There need not be an adjustment for losses, but such an adjustment is permitted. If the plan allowed for participant directed investments at the time of the failure, and, therefore, a number of different investments were permitted, the plan is permitted to use the highest rate earned in the plan for the year of the failure. This method is applicable if most of the affected participants are NHCEs.

Note. If it is not feasible to make a reasonable estimate of what the actual investment results would have been, a special rule allows the sponsor of a SEP or SIMPLE IRA plan to use a reasonable rate of interest.⁶³

⁶⁰ Rev. Proc. 2006-27, Section 6.10(1)-(5), 2006-22 IRB 945.

⁶¹ Rev. Proc. 2006-27, Sections 5.01(3), 6.10(5), 2006-22 IRB 945.

⁶² Rev. Proc. 2006-27, Section 5.01(a), 2006-22 IRB 945.

⁶³ Rev. Proc. 2006-27, Section 6.10(4)(b)(ii), 2006-22 IRB 945.

Corrective allocations for a prior plan year are considered an annual addition for the year to which the correction applies, not for the year in which the corrective allocations are made. The normal rules of IRC Section 404, however, apply for deduction purposes.⁶⁴ This means that the employer will generally not receive a deduction. Corrective allocations can come only from employer contributions.

To correct an operational failure under the VCP, an employer must do the following:

1. Satisfy submission requirements.
2. Correct the failure identified in accordance with the compliance statement.
3. Pay the required compliance fee.

Insufficient Information

The failure cannot be corrected under the VCP under the following conditions:

- It is not possible to obtain sufficient information to determine the nature or extent of a failure.
- There is insufficient information to effect proper correction.
- The application of the VCP for SEP would be inappropriate or impractical.

Amendment to Correct

As mentioned previously, correction by plan amendment is permitted under SCP for a limited category of operational failures, and is generally available to correct a wider variety of failures under VCP and Audit CAP. A plan sponsor may also use VCP to correct a “nonamender failure,” defined as a failure to amend a plan to reflect a change in qualification requirements within the plan’s applicable remedial amendment period or cycle.⁶⁵ A plan sponsor must submit a determination letter application, using the appropriate Form 5300 series form, for correction of a nonamender failure (except where the correction can be made through adoption of an IRS model amendment or adoption of a prototype or volume submitter plan).

The IRS will also issue determination letters to correct qualification failures in a VCP filing submitted for a terminating plan or a terminating plan under examination, or to correct a failure in a plan that is being examined during the last 12 months of the plan’s remedial amendment cycle, as defined in Section 13 of Revenue Procedure 2005-6 (an “on-cycle filing”).⁶⁶ The IRS reserves the right to require the submission of a determination letter application with respect to any amendment proposed or adopted to correct any qualification failure under VCP.⁶⁷

In corrective amendment cases where a determination letter is not issued, the IRS compliance statement or closing agreement will constitute a determination on the tax-qualified status of the plan, as amended, except with regard to the following: (1) good faith EGTRRA amendments; (2) amendments for final and temporary 401(a)(9) regulations; and (3) interim amendments under Section 5 of Rev. Proc. 2005-66, 2005-37 I.R.B. 509.⁶⁸

⁶⁴ IRC Section 404(j).

⁶⁵ Rev. Proc. 2006-27, Section 4.06(1), 2006-22 IRB 945.

⁶⁶ Rev. Proc. 2006-27, Section 4.06(1), 2006-22 IRB 945.

⁶⁷ Rev. Proc. 2006-27, Section 4.06 (1), 2006-22 IRB 945.

⁶⁸ Rev. Proc. 2006-27, Section 4.06(1), 2006-22 IRB 945.

Application for Compliance Statement

Generally, the request under the program from the employer consists of a letter indicating the description of the failures, methods of correction, and any other procedural items. In the case of a VCP submission, the following is required:⁶⁹

1. A statement identifying the type of plan submitted
2. A description of the applicable correction and failures and the years in which the failures occurred
3. A description of the administrative procedures in effect at the time the failures occurred
4. An explanation of how and why the failures occurred
5. A description of the methodology that will be used to calculate earnings
6. The method that will be used to locate and notify former employees and beneficiaries
7. A description of the measures that have been implemented to ensure that the same failures will not occur
8. A statement that neither the employer nor the plan is under examination⁷⁰
9. A statement that the employer proposes to implement (or has implemented) the correction(s)
10. The information generally included on the first three pages of Form 5500, including the name and number of the plan and the employer's identification number (EIN) (The information is needed even if the plan is not subject to Form 5500 series filing requirements.)
11. A copy of the SEP or SIMPLE document
12. A copy of the most recent opinion letter for a prototype SEP or SIMPLE, or a copy of the IRS current Model SEP on Form 5305-SEP, Simplified Employee Pension Individual Retirement Accounts Contribution Agreement; or Form 5305A-SEP, Salary Reduction Simplified Employee Pension Individual Retirement Accounts; or a copy of the IRS current Model SIMPLE Plan on Form 5305-SIMPLE or 5304-SIMPLE
13. The initial VCP fee (\$500 for SEP or SIMPLE), which must be included with the submission
14. The signature of the employer or their representative and the "penalty of perjury statement"

Corrections of Operational Failures

The following is a brief description of operational failures and corrections under the SCP and VCP for SEP and SIMPLE IRA. In each case, the method described corrects the operational failure identified. Corrective allocations and distributions should reflect earnings. The corrections listed are those that may work with a SEP or SIMPLE, although some need modification:

- *Failure to properly provide the minimum top-heavy benefit under IRC Section 416 to nonkey employees.* In a SEP (or SARSEP) plan, the permitted correction method is to properly contribute and allocate the required top-heavy minimums to the SEP IRA in the manner provided for in the plan on behalf of the nonkey employees (and any other employees required to receive top-heavy allocations under the plan).

⁶⁹ See Rev. Proc. 2006-27, Section 11.02, 2006-22 IRB 945.

⁷⁰ See Rev. Proc. 2006-27, Section 5.03, 2006-22 IRB 945. If a plan sponsor has submitted a determination letter request as part of a correction under EPCRS, and the examiner identifies additional qualification failures, the plan will be considered to be "under examination" with regard to the identified defects, even if the plan sponsor subsequently withdraws the determination letter application.

- *Failure to satisfy the SARSEP ADP test.* The permitted correction method is to make qualified nonelective contributions (QNEC) (employer contribution) on behalf of the NHCEs to the extent necessary to raise the ADP of the NHCEs to the percentage needed to pass the test.⁷¹ The contributions must be made on behalf of all eligible NHCEs (to the extent permitted under IRC Section 415) and must either be the same flat dollar amount or the same percentage of compensation. The one-to-one correction method may also be used.
- *Deferral percentage test failures.* This method, also known as the one-to-one correction method, may be used. Under this method, there is a corrective distribution of excess contributions and an equivalent corrective contribution made to the plan which is allocated to NHCEs only.
- *Failure to distribute elective deferrals in excess of the IRC Section 402(g) limit.*⁷² The permitted correction method for a SEP or SIMPLE is to distribute the excess deferral to the employee and to report the amount as taxable in the year of deferral and the year distributed. A distribution to an HCE is included in the ADP test; a distribution to a NHCE is not included in the ADP test. A distribution is reported as taxable on Form 1099-R for the year of the distribution. The employee is also required to amend their tax return for the year of the excess deferral and claim the excess on line 7 of their Form 1040.
- *Exclusion of eligible employee in a non-safe-harbor 401(k) plan*⁷³ Formerly, a plan sponsor's only correction option was to make a qualified non-elective contribution (QNEC) in a percentage equal to the average deferral percentage (ADP) for the compensation group to which the excluded employee belonged (whether highly compensated employees (HCEs) or non-highly compensated employees (NHEs)), and, if the plan included matching contributions, to make an additional QNEC in a percentage equal to the average contribution percentage (ACP) for the excluded employee's compensation group. The IRS now views this correction method as creating a windfall to the excluded employee, because he or she did not have to defer any portion of compensation under the plan in order to receive the QNECs. The IRS now defines the correction as the excluded employee's "lost opportunity" cost—what it cost the employee to not have a portion of his or her compensation contributed to the plan on a pre-tax basis, taking into account future tax-free growth. Therefore the "new" correction method is to make a QNEC equal to 50 percent of the "missed deferral" that otherwise would have been made under the "old" method, multiplied by the excluded employee's compensation. The new corrective method for matching contributions is to make a QNEC equal to matching contribution that would have been made based on 100 percent of the missed deferral, not on the 50 percent lost opportunity cost.⁷⁴

Example. Mavis, a non-highly compensated employee earning \$60,000 per year, is incorrectly excluded from a plan that provides a matching contribution equal to 100 percent of the first 3 percent of compensation. The average deferral percentage for the NHE group is 4 percent. Mavis' lost opportunity cost is equal to \$1,200 (\$60,000 times 4 percent times 50 percent). However the correction for her matching contribution is \$1,800 (\$60,000 times 3 percent).

⁷¹ See, Treas. Reg. Section 1.401(k)-1(g)(13).

⁷² In contravention of IRC Section 401(a)(30).

⁷³ Rev. Proc. 2006-27, Section 6.02(7), Appendix A.05, Appendix B Section 2.02, 2006-22 IRB 945.

⁷⁴ Failure to implement automatic 401(k) enrollment procedures would also likely require correction based on the "lost opportunity" method, with the automatic deferral percentage standing in for the peer-group ADP.

- *Exclusion of eligible employee in a safe harbor 401(k) plans.*⁷⁵ The new correction is also based on “lost opportunity costs,” however, in calculating the corrective contribution the safe harbor formula is used, rather than the ADP amounts for the applicable class of employees. Thus, for plans that use a non-elective safe harbor contribution equal to 3 percent of compensation, the missed deferral is deemed to be 3 percent of compensation, and the lost opportunity cost (and corrective contribution) is 50 percent of 3 percent of compensation. The plan must also make the 3 percent non-elective safe harbor contribution in the form of an additional QNEC. For plans that use a matching contribution safe harbor, the missed elective deferral is deemed to be the greater of (a) 3 percent of compensation, or (b) the maximum deferral percentage for which plan provides a matching contribution. The QNEC for the matching contribution is equal to the matching contribution that would have been made if the employee had made the “deemed” pre-tax deferrals. Of course, the amounts are to be adjusted for earnings.
- *Exclusion of eligible employee in a plan with after-tax contributions.* The correction here is to make a QNEC equal to 40 percent of the participant’s “missed after-tax employee contribution,” which is calculated in a manner similar to the missed salary deferral, as explained previously.
- *Failure to obtain spousal consent*⁷⁶ There are two permitted correction methods: (a) provide the spouse a benefit equal to the portion of the qualified joint and survivor annuity that would have been payable to the spouse under the plan at the annuity starting date of the prior distribution; and (b) provide the spouse with a lump-sum distribution equal in amount to the present value of the annuity determined under correction method (a). The lump-sum should be calculated using interest and mortality factors contained in IRC Section 417(e)(3).
- *Exclusion of an eligible employee from a SEP or SARSEP.* The permitted correction method is to make a contribution to the plan on behalf of the employees excluded from a SEP or SIMPLE IRA. If the employee should have been eligible to make an elective contribution under a SARSEP arrangement or SIMPLE IRA, the employer must make a QNEC to the plan on behalf of the employee that is equal to the ADP for the employee’s group (either HCE or NHCE). Contributing the ADP for such employees eliminates the need to rerun the ADP test to account for the previously excluded employees.

The administrator may use a prorated amount for the excluded employee’s compensation for the portion of the year that the employee was excluded.⁷⁷

Corrective contributions, with respect to the missed elective deferrals, are not required if an employee has been permitted to defer to the plan for a period of at least nine consecutive months during the plan year.⁷⁸

- *Failure to timely pay the minimum distribution required under IRC Section 401(a)(9).* In a SEP IRA or SIMPLE IRA, the permitted correction method is to distribute the required minimum distributions (RMDs). The amount to be distributed for each year in which the failure occurred should be determined by dividing the adjusted account balance on the applicable valuation date by the applicable divisor. For this purpose, adjusted account balance means the actual account balance, determined in accordance with the proposed regulations, reduced by the amount of the total missed minimum distributions for prior years.

⁷⁵ Rev. Proc. 2006-27, Section 6.02(7), Appendix A.05, Appendix B Section 2.02, 2006-22 IRB 945.

⁷⁶ Rev. Proc. 2006-27, Section 6.04, 2006-22 IRB 945.

⁷⁷ Rev. Proc. 2006-27, Appendix B Section 2.02(1)(a)(ii)(E), 2006-22 IRB 945.

⁷⁸ Rev. Proc. 2006-27, Appendix B Section 2.02(1)(a)(ii)(F), 2006-22 IRB 945.

- *Failure to satisfy the IRC Section 415(c) limits in a defined contribution plan.* The permitted correction for failure to limit annual additions (other than elective deferrals) allocated to participants in a SEP or SIMPLE plan as required in IRC Section 415(c) (even if the excess did not result from a reasonable error in estimating compensation) is to place the excess annual additions into an unallocated account, similar to the suspense account, to be used as an employer contribution in the succeeding year(s). Although such amounts remain in the unallocated account, the employer is not permitted to make additional contributions to the plan. The permitted correction for failure to limit annual additions that are elective deferrals (even if the excess did not result from a reasonable error in determining the amount of elective deferrals that could be made with respect to an individual under the IRC Section 415 limits) is to distribute the elective deferrals or employee contributions using a method similar to that described under the regulations.
- *Correction of exclusion of eligible employees in employer contribution to SEP and SIMPLE.* Additional nonelective contribution must be made on behalf of the excluded employee, adjusted for earnings. If, due to the additional contribution, there should be a reduction in another employee's contribution, no reduction is made. However, if the alternate reallocation method is used, the original contribution made is reallocated to include the excluded employee(s). This will require some employees to receive decreases in their account balances. If the aggregate amount of decreases exceeds the aggregate amount of increases, then the employer must make a nonelective contribution to the plan to take care of the difference.
- *Correction of IRC Section 415 failures.* There are two methods to correct excesses under IRC Section 415:
 - *Forfeiture correction method.* This method may be used for a NHCE who has an excess IRC Section 415 addition and has separated from service with no vested interest in the matching or nonelective contribution and has not been reemployed at the time of correction.
 - *Return of overpayment correction method.* The employer may take appropriate steps to have the employee return the overpayment (a *de minimis* rule of \$100 applies), plus earnings to the plan. The employer must also indicate to the employee who received the overpayment that such payment is eligible for neither rollover treatment nor favorable tax treatment.
- *Other overpayment failures.* SEP and SIMPLE overpayments are corrected under IRC Section 415(c) using the return of overpayment method described above. Revenue Procedure 2003-44 clarifies that if the SEP IRA or SIMPLE retains the overpayment, the employer is subject to the 10-percent tax in addition to the VCP SEP submission fee.
- *Correction of IRC Section 401(a)(17) failures.* Under the reduction of account balance method, the account balance of an employee who received an allocation on the basis of compensation in excess of the IRC Section 401(a)(17) limit (\$45,000 for 2007, plus catch-up elective deferrals) is reduced by the improperly allocated amount (adjusted for earnings). If the improperly allocated amount would have been allocated to other employees in the year of the failure if the failure had not occurred, then that amount (adjusted for earnings) is reallocated to those employees in accordance with the plan's allocation formula. A qualified plan can go further if the improperly allocated amount would not have been allocated to other employees absent the failure, that amount (adjusted for earnings) is placed in an unallocated account⁷⁹ to be used to reduce employer contributions in succeeding year(s). For example, if a plan provides for a fixed level of employer contributions for each eligible employee, and the plan provides that forfeitures are used to reduce future employer contributions, the improperly allocated

⁷⁹ Similar to the suspense account described in the Treas. Reg. Section 1.415-6(b)(6)(iii).

amount (adjusted for earnings) would be used to reduce future employer contributions. This second step is not available for SEP or SIMPLE.

- *Correction of inclusion of ineligible employee failure by plan amendment.* The plan may be amended retroactively to change the eligibility requirements to allow the ineligible employee to become eligible. All other employees who become eligible due to the amendment must be covered as well. Unfortunately, there are no SEP or SIMPLE examples in Revenue Procedure 2006-27.⁸⁰ Even though the IRS has added SEP and SIMPLE IRA to the EPCRS, additional guidance is needed. Furthermore, the VCP rules do address how an employer is to effectuate a distribution in the case of an IRA-based plan, especially if the employee is reluctant to do so. Employers are not parties to the IRA arrangements established by their employees, although that agreement is an integral part of the employer-employee relationship.
- *Corrections related to plan loans.* Under VCP, the IRS will permit correction of certain failures related to plan loans, including loan amounts that exceeded the maximum permissible limit under IRC 72(p)(2)(A), loan periods that exceeded the maximum period under IRC Section 72(p)(2)(B), loans made under plans that did not include loan provisions, and loan defaults that were not timely reported as a taxable distribution, so long as the statutory repayment period has not expired.⁸¹ With regard to loan defaults, VCP provides relief from treatment of the defaulted loan as a distribution provided that the error is corrected by (a) making a lump-sum payment (plus interest) to “catch-up” on missed payments; (b) re-amortizing the loan; or (c) a combination of both methods.⁸²

VCP Fees

Fees for Qualified Plans

The basic fee to participate in VCP is based on the number of participants/employees covered under a plan, and ranges from \$750 for plans with 20 or fewer employees, to \$25,000 for plans with over 10,000 employees. A reduced, flat compliance fee of \$375 applies where the sole failure is failure timely to adopt good faith EGTRRA amendments, amendments to conform to temporary and interim regulations on minimum required distributions under Section 401(a)(9); and/or interim amendments under Revenue Procedure 2005-66.⁸³

Revenue Procedure 2006-27 contains a new fee schedule applicable to “non-amender” issues that are not related to the submission in question and that are discovered during the determination letter process. The fee is based upon the number of participants in the plan, and the type of required amendment that was not timely made, and ranges from \$2,500 for a plan with 20 or fewer employees that failed to timely amend for EGTRRA, at the low end, to \$80,000 for a plan with more than 10,000 employees that failed to amend for ERISA.⁸⁴

Fees for SEP and SIMPLE IRAS

The fee that applies under the VCP program for SEP and SIMPLE is generally \$250; however, the IRS reserves the right to use the fee schedule applicable to qualified plans and 403(b) plans, or the fee schedule for egregious failures, in appropriate circumstances.⁸⁵ In cases in which the employer is using its own correction method (and not one outlined by the IRS under Revenue Procedure 2006-27), the IRS will charge an (undisclosed) additional fee. Also, if the failure involves an excess amount that is retained in the SEP or SIMPLE

⁸⁰ 2006-21 IRB.

⁸¹ Rev. Proc. 2006-27, Sections 6.02(6), 6.07, 2006-22 IRB 945.

⁸² Rev. Proc. 2006-27, Section 6.07(3), 2006-22 IRB 945.

⁸³ Rev. Proc. 2006-27, Section 12.03, 2006-22 IRB 945.

⁸⁴ Rev. Proc. 2006-27, Section 14.04, 2006-22 IRB 945.

⁸⁵ Rev. Proc. 2006-27, Section 12.05(1), 2006-22 IRB 945.

IRA, a fee equal to at least 10 percent of the excess amount excluding earnings will be imposed. The compliance fee for egregious failure may be a negotiated amount.⁸⁶

The group submission fees have been reduced to \$10,000 for the first 20 plans and \$250 for each additional plan, up to a maximum of \$50,000. If more than one master or prototype plan is submitted as a group submission, each master or prototype plan is considered a separate group submission for purposes of the compliance fee.⁸⁷ Finally, for all VCP requests, the fee must be submitted with the initial application and need not be paid in the form of a certified or cashier's check. Thus, the correction methods for SIMPLE IRA and SEP are very similar to those for qualified plans. For certain failures, however, Revenue Procedure 2006-27 provides specific correction methods and reporting requirements that are unique to the circumstances of SIMPLE IRA and SEP.

Note. Arguably, the plan sponsor (generally, the employer) is not retaining any *excess amount* in the SEP or SIMPLE IRA for purposes of the additional fee which is equal to at least 10 percent of the excess amount retained in the plan imposed when the plan sponsor “retains the Excess Amount.”⁸⁸

If there is a *de minimis* excess amount of \$100 or less attributable to elective deferrals or employer contributions, the plan sponsor is not required to distribute the excess amount and the special fee will not apply.⁸⁹

DOL Voluntary Fiduciary Correction Program (VFCP)

Purpose of VFCP

The Voluntary Fiduciary Correction Program (VFCP) allows plan sponsors and other plan fiduciaries to voluntarily disclose certain transactions to the Department of Labor, and, by correcting the transactions in accordance with the VFCP, to avoid potential civil actions, penalties, and the assessment of civil penalties under Section 502(i) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). In general, the relief available under the VFCP affects plans, participants, and beneficiaries of such plans in connection with investigation or civil action by the DOL.⁹⁰

Introduced on an interim basis in 2000, the VFCP was first published in March 2002, and was updated on a “proposed” basis in April 2005. Those proposed changes were finalized and supplemented in April 2006. A final class exemption to permit certain transactions identified in the proposed VFCP, first issued on November 25, 2002, was also updated together with the VFC program in April 2006.⁹¹ The IRS grants relief from

⁸⁶ Rev. Proc. 2006-27, Section 12.05(2), 2006-22 IRB 945.

⁸⁷ Rev. Proc. 2006-27, Section 12.04, 2006-22 IRB 945.

⁸⁸ Rev. Proc. 2006-27, Sections 6.10(5)(b), 12.05(2). Rather, such amounts are generally retained by the trustees and custodians of the prototype and model IRA document sponsor(s) of the IRA arrangements established by participating employees. The employer is not a party to the agreements establishing the SIMPLE IRAs and has neither dominion nor control over the assets in such an arrangement, nor does the plan sponsor have any control as to their investment or disposition. The plan sponsor is not authorized to order, direct, or to effectuate any distribution from the SIMPLE IRA accounts; all such rights in the account reside solely to the employee that established the account. Rarely is the plan sponsor the trustee or custodian of the assets held in the SIMPLE IRAs. On the other hand, if a “group or employer-sponsored” individual retirement arrangement under IRC Section 408(c) is used or there is a group or common trust, the plan sponsor would generally and more arguably be subject to the extra fee. Furthermore, in the case of an employer eligibility failure, the revenue procedure requires that “the assets in such plan are to remain in the trust, annuity contract, or custodial account” until a distribution event has occurred. See Rev. Procedure 2006-27 Section 6.03(1).

⁸⁹ Rev. Proc. 2006-27, Section 6.10(5)(c).

⁹⁰ Voluntary Fiduciary Correction Program, 71 Fed. Reg. 75, 20262-20285. This version of the VFCP took effect May 19, 2006.

⁹¹ PTE 2002-51 (App No D-10933). 67 Fed. Reg. 227, 70623-70628; Amended at 71 Fed. Reg. 75, 20135-20139.

excise taxes under IRC Section 4975 consistent with VFCP, but only for certain transactions, including late transmittal of salary deferral contributions, and only upon notification of affected participants.⁹²

The purpose of the VFCP is to protect the financial security of workers by encouraging the identification and correction of transactions that violate Part 4 of Title I of ERISA. Part 4 of Title I of ERISA sets out the responsibilities of employee benefit plan fiduciaries.

Section 409 of ERISA provides that a fiduciary who breaches any of these responsibilities shall be personally liable to make good to the plan any losses to the plan resulting from each breach and to restore to the plan any profits the fiduciary made through the use of the plan's assets.

Section 405 of ERISA provides that a fiduciary may be liable, under certain circumstances, for a co-fiduciary's breach of his or her fiduciary responsibilities. In addition, under certain circumstances, there may be liability for knowing participation in a fiduciary breach. In order to assist all affected persons in understanding the requirements of ERISA and meeting their legal responsibilities, the Employee Benefits Security Administration (EBSA), formerly the Pension and Welfare Benefits Administration (PWBA), provided guidance on what constitutes adequate correction under Title I of ERISA for the breaches described in the VFCP.

The VFCP also applies to a SEP, SARSEP, or SIMPLE IRA if the plan is subject to ERISA. SEP, SARSEP, and SIMPLE are subject to ERISA if there is at least one common-law employee participating in the plan.

Effect of the VFCP

In general, the EBSA will issue to the applicant a no-action letter with respect to a breach identified in the application of an eligible person or entity, and the breach is corrected. Pursuant to the no-action letter it issues, the EBSA will not initiate a civil investigation under Title I of ERISA regarding the applicant's responsibility for any transaction described in the no-action letter, or assess a civil penalty under ERISA Section 502(l) on the correction amount paid to the plan or its participants. Relief from civil penalties applicable to welfare plans and nonqualified pension plans under ERISA Section 502(i) also became available in the revisions finalized in 2006.

Program Eligibility

An applicant must meet three criteria in order to participate in the VFCP: (a) neither the plan nor the applicant is "under investigation"; (b) there is no evidence of potential criminal violations, as determined by EBSA, and (c) EBSA has not conducted an investigation which resulted in written notice to a plan fiduciary that the transaction has been referred to the IRS.⁹³

⁹² IRS Ann. 2002-31, 2002-15 IRB 747.

⁹³ Voluntary Fiduciary Correction Program Section 3(b)(3) defines "Under Investigation" to include the following: (a) EBSA is investigating the plan; (b) EBSA is investigating the potential applicant or plan sponsor in connection with an act or transaction directly related to the plan; (c) any governmental agency is conducting a criminal investigation of the plan, or of the potential applicant or plan sponsor in connection with an act or transaction directly related to the plan; (d) the TE/GE Division of the IRS is conducting an Employee Plans examination of the plan; (e) the plan, applicant or sponsor is under investigation by the PBGC, any state attorney general or any state insurance investigator.

Eligible Transactions

Nineteen categories of eligible transactions may be corrected under the VFPC; some of which include the following:⁹⁴

1. The failure to timely transmit participant contributions.
2. The making of a loan by a plan at a fair-market interest rate to a party in interest with respect to the plan.
3. The making of a participant loan that exceeds maximum loan amount, loan period, or level amortization rules.
4. The purchase or sale of an asset (including real property) between a plan and a party in interest at fair market value (FMV).
5. The sale of real property to a plan by the employer and the leaseback of such property to the employer, at FMV and fair market rental value, respectively.
6. Certain circumstances where a plan acquired an illiquid asset and the only available purchaser is a party in interest.
7. Payment of expenses by the plan that should have been paid by the plan sponsor.

If an application is rejected, the applicant may be subject to enforcement action, including assessment of civil monetary penalties under ERISA Section 502(l).

Fiduciary Correction Methods

The VFPC provides acceptable correction methods for the failures listed above. As part of the correction process, applicants must:

- Conduct valuations of plan assets using generally recognized markets for the assets or obtain written appraisal reports from qualified professionals that are based on generally accepted appraisal standards.
- Restore to the plan the principal amount involved, plus the greater of (1) the lost earnings starting on the date of the loss and extending to the recovery date, or (2) the profits resulting from the use of the principal amount for the same period.
- Pay the expenses associated with the correction process, such as appraisal costs or the cost of recalculating participant account balances.
- Make supplemental distributions to former employees, beneficiaries, or alternate payees when appropriate and provide proof of the payments.

⁹⁴ The full list of correctible transaction is as follows: (1) delinquent participant contributions to pension plans; (2) delinquent participant contributions to insured welfare plans; (3) delinquent participant contributions to self-funded welfare plan trusts; (4) fair market interest rate loans with parties in interest; (5) below market interest rate loans with parties in interest; (6) below market interest rate loans with nonparties in interest; (7) below market interest rate loans due to delay in perfecting security interest; (8) participant loans that fail to comply with limits on the loan amount, loan duration, or loan amortization schedule; (9) defaulted loans; (10) purchase of assets by plans from parties in interest; (11) sale of assets by plans to parties in interest; (12) sale and leaseback of property to sponsoring employers; (13) purchase of assets from nonparties in interest at above market value; (14) sale of assets to nonparties in interest at below market value; (15) holding of an illiquid asset previously purchased by the plan; (16) benefit payments based on improper valuation of plan assets; (17) payment of duplicate, excessive, or unnecessary compensation; (18) expenses improperly paid by a plan; and (19) payment of dual compensation to plan fiduciaries.

EBSA now provides an online calculator, found at <http://askebsa.dol.gov/VFCPCalculator/WebCalculator.aspx>, which allows applicants to calculate lost earnings and interest, and compare that amount to restoration of profits. Generally, the greater amount must be paid to the plan. The calculator is also able to calculate corrections involving multiple transactions with different time periods.

VFC now allows a plan that has purchased an asset from a party in interest to retain the asset and to correct the transaction by receiving a settlement amount in cash from the party in interest. Formerly, VFCP required the plan to divest the asset.

Application Documentation

A VFCP applicant must submit the following documentation to the appropriate regional office of the EBSA, formerly the PWBA:

- Copy of relevant portions of the plan and related documents
- Documents supporting transactions, such as leases and loan documents and applicable corrections
- Documentation of lost earnings amounts
- Documentation of restored profits, if applicable
- Proof of payment of required amounts
- Certain documents required for relevant transactions
- Signed checklist
- Penalty of perjury statement

Abbreviated documentation rules apply to delinquent participant contributions and loan repayments to pension plans, and to delinquent participant contributions to insured or self-funded welfare plans. The abbreviated rules apply to applicants correcting breaches involving amounts (a) under \$50,000 or (b) greater than \$50,000 but that were remitted to the plan within 180 days after receipt by the employer. Full documentation rules apply to applicants who fail to meet the \$50,000 and 180 day standards.

EBSA reserves the right to make written request for supplemental documentation needed to complete the review process.

EBSA now provides a model application form that can be found at <http://www.dol.gov/ebsa/calculator/vfcapplicationrevised.html>. Use of the model form is voluntary but recommended. Like an EPCRS applicant, a VFCP applicant must restore the plan, the participants, and their beneficiaries to the condition they would have been in had the breach not occurred. Plans must also file, if necessary, amended returns to reflect corrected transactions or valuations.⁹⁵

Under the VFCP, applicants must also provide proof of payment to participants and beneficiaries or properly segregate affected assets if the plan is unable to locate missing individuals.

Payment of the correction amount may be made directly to the plan if distributions to separated participants would be less than \$20 and the cost of correction would exceed the distributions owed. Applicants can use the blended rate (in lieu of the highest rate) in calculating the rate of return on affected transactions involving ERISA Section 404(c) plans only for affected participants who have not made investment allocations.

⁹⁵ In the preamble to the VFCP program, as revised in 2006, the EBSA declined to create a "de minimis" rule that would require filing of amended Form 5500 only if the fiduciary breach involved a defined threshold of plan assets. Plan sponsors should therefore file amended Form 5500 in accordance with Form instructions for the years involved in the corrected fiduciary breach.

Prohibited Transaction Excise Tax

As mentioned, a prohibited transaction class exemption (PTE 2002-51) issued in conjunction with the VFCP provides limited relief from the excise taxes under IRC Section 4975 on certain transactions covered by the VFCP. As amended effective May 19, 2006, the exemption applies to the following transactions:

- Failure to timely remit participant contributions to plans⁹⁶
- Loans made at fair market interest rates by plans to parties in interest
- Purchases or sales of assets between plans and parties in interest at FMV
- Sales of real property to plans by employers and leaseback of the property, at FMV and fair market rental value, respectively
- Plan acquisition of an illiquid asset, and subsequent sale to a party-in-interest; and
- The use of plan assets to pay for settlor expenses, as opposed to plan expenses

Under the exemption, a VFCP applicant must repay delinquent contributions to the plan no more than 180 days from the date the money was received by the employer or would be payable to plan participants in cash.

The exemption also requires the following:

- No more than 10 percent of the FMV of total plan assets may be involved (except for delinquent employee contributions).
- Notice of the transaction and the correction must be provided to interested persons.⁹⁷
- Transactions covered under the exemption cannot be part of an arrangement or understanding that benefits a related party.

The exemption does not apply to any transaction similar to a transaction for which an application has been submitted under the VFCP within the past three years.

Additionally, the preamble to the updated PTE 2002-51 makes it clear that neither the prohibited transaction exemption nor VFCP apply to IRAs that are not subject to ERISA. Relief for transactions involving non-ERISA IRAs is only available through the DOL's individual administrative exemption process.

Additional VFCP Information

Additional information on the VFCP can be obtained by contacting the EBSA at (866) 275-7922 and requesting the VFCP coordinator. Questions about the proposed prohibited transaction exemption should be directed to the Office of Exemption Determinations at (202) 693-8540.⁹⁸

⁹⁶ 29 C.F.R. Section 2510.3-102.

⁹⁷ An exception to the notice requirement applies where the transaction at issue is the failure to timely transmit participant contributions or loan repayments, and the applicable excise tax (as determined using the DOL Online Calculator) does not exceed \$100, provided that the excise tax amount is contributed to the plan and allocated to participants consistent with the plan's allocation formula. This relief is only available if the plan sponsor requests a no-action letter under the VFCP and provides documentation of this correction along with the VFCP application. Late deferral amounts must still be reported on Form 5500.

⁹⁸ For additional information, see EBSA's "Frequently Asked Questions about the Voluntary Fiduciary Correction Program" at http://www.dol.gov/ebsa/faqs/faq_vfcp.html.

DOL Delinquent Filer Voluntary Compliance Program

The Delinquent Filer Voluntary Compliance (DFVC) Program is designed to encourage voluntary compliance with the annual reporting requirements under ERISA. The program gives delinquent plan administrators a way to avoid potentially higher civil penalty assessments by satisfying the program's requirements and voluntarily paying a reduced penalty amount.⁹⁹ The acceptance of a filing and receipt of penalty payments does not represent a determination by the DOL as to the status or type of plan.¹⁰⁰

Eligibility

Eligibility for the DFVC Program continues to be limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA.^{101, 102}

Program Criteria

Participation in the DFVC Program is a two-part process:¹⁰³

1. File a complete Form 5500 Series Annual Return/Report, including all schedules and attachments, for each year relief is requested to the EBSA.¹⁰⁴
2. Submit the required documentation and applicable penalty amount to the DFVC Program.

If the Form 5500 is being filed under the DFVC Program, check Form 5500, Part I, box D, and attach a statement explaining that the Form 5500 is being filed under the DFVC Program with "Form 5500, Box D—DFVC FILING" prominently displayed at the top of the statement.

Liability

The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVC Program shall not be paid from the assets of an employee benefit plan.¹⁰⁵

Penalty Structure¹⁰⁶

The basic penalty under the program is \$10 per day for delinquent filings. The maximum penalty for a single late annual report is \$750 for a small plan (generally, a plan with fewer than 100 participants at the beginning of the plan year) and \$2,000 for a large plan.

To encourage reporting compliance by plan administrators who have failed to file an annual report for a plan for multiple years, there is a per plan cap limits of \$1,500 for a small plan and \$4,000 for a large plan regardless of the number of late annual reports filed for the plan at the same time. There is no per

⁹⁹ 67 Fed. Reg. 60, 15052 (March 28, 2002).

¹⁰⁰ The DFVC Notice was published in the Federal Register on March 28, 2002 (67 Fed. Reg. 60, Preamble at 15052, Notice at 15058). See Section 5.04.

¹⁰¹ DFVC Notice Section 1, 67 Fed. Reg. 60 (March 28, 2002)

¹⁰² For example, Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3-3(b) and (c)) are not eligible to participate in the DFVC Program because such plans are not subject to Title I.

¹⁰³ DFVC Notice Section 3, 67 Fed. Reg. 60 (March 28, 2002).

¹⁰⁴ Special simplified rules apply to top-hat plans and apprenticeship and training plans.

¹⁰⁵ DFVC Notice Section 3.04, 67 Fed. Reg. 60 (March 28, 2002).

¹⁰⁶ DFVC Notice Section 3.03, 67 Fed. Reg. 60 (March 28, 2002).

administrator or per sponsor cap. If the same person is the administrator or sponsor of several plans required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.¹⁰⁷

A special per plan cap of \$750 applies to a small plan sponsored by an organization that is tax-exempt under IRC Section 501(c)(3). The \$750 limitation applies regardless of the number of late annual reports filed for the plan at the same time. It is not available, however, if, as of the date the plan files under the DFVC Program, there is a delinquent annual report for a plan year during which the plan was a large plan.

The penalty amount for top-hat plans and apprenticeship and training plans is \$750.¹⁰⁸

Plan administrators may use the Form 5500 for the year relief is sought or the most current form available at the time of participation. This option allows administrators to choose the form that is most efficient and least burdensome for their circumstances.

Extension of Time to File

A one-time extension of time to file Form 5500 (up to two and one-half months) is available by filing Form 5558, Application for Extension of Time To File Certain Employee Plan Returns, on or before the normal due date (not including any extensions) of the return/report. You *must* file Form 5558 with the IRS. A photocopy of the extension request that was filed must be attached to the Form 5500.

An automatic extension of time to file Form 5500 until the due date of the federal income tax return of the employer will be granted if all of the following conditions are met:

1. The plan year and the employer's tax year are the same.
2. The employer has been granted an extension of time to file its federal income tax return to a date later than the normal due date for filing the Form 5500 (except IRS Form 8736, Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC, or for Certain Trusts).
3. A copy of the application for extension of time to file the federal income tax return is attached to the Form 5500.

An extension granted by using Form 5558 cannot be extended further by filing another Form 5558.

Abatement for Reasonable Cause

If a nonfiling penalty has already been assessed, it may be possible to have the penalty abated by establishing reasonable cause with the IRS.¹⁰⁹ For example, a request to have the penalties abated for reasonable cause might include the following:

An additional extension of time for the filing of Form 5500-C (and related schedules) is needed because circumstances beyond the taxpayer's control have prevented the proper compilation of data to the full extent necessary for the completion of the ____, ____ and ____ pages of the 200____ Form 5500. In order for the taxpayer to complete each of the questions in a manner that will most accurately relate the state of the plan in accordance with instructions issued jointly by the Internal Revenue Service and the Department of Labor,

¹⁰⁷ Some employers that sponsor several welfare benefit plans, each subject to Form 5500 filing obligations, have submitted the plans under the DFVC program as a single "wrapped" arrangement, thereby reducing the number of delinquent filings at issue. Expert legal advice is recommended in such situations, as "wrapping" together multiple welfare plan arrangements may have other consequences that complicate, rather than simplify, plan administration.

¹⁰⁸ DFVC Notice Section 4.02, 67 Fed. Reg. 60 (March 28, 2002).

¹⁰⁹ Internal Revenue Manual ("IRM") Parts 8.11.13, 20.1.3.

there is need to properly clarify and refine pertinent data thus far accumulated. So that the taxpayer may file the Annual Return/Report in a form that is no way incomplete nor otherwise insufficient, the taxpayer needs an extension of the filing deadline. Only with approval of the extension request will the taxpayer be able to proceed in a manner that will facilitate the proper realignment of all data in a manner fully consistent with the intent of ERISA.

[State the reasons, facts, and circumstances.]

On behalf of the plan, I respectfully request that an extension be granted and any late filing penalties be abated in light of the aforementioned facts and circumstances. I unhesitatingly believe that the taxpayer had reasonable cause sufficient to a person of ordinary prudence so as to warrant an abatement for reasonable cause in accordance with Internal Revenue Manual.

IRS and PBGC Participation

Although the DFVC Program does not cover late filing penalties under the Internal Revenue Code or Title IV of ERISA, the IRS and PBGC agreed to provide certain penalty relief for delinquent Form 5500s filed for Title I plans where the conditions of the DFVC Program have been satisfied.¹¹⁰

Additional Information

For additional information and questions about the DFVC Program, contact the EBSA at (202) 693-8360. For additional information about the Form 5500 Series, visit the EFAST Internet site at www.efast.dol.gov, or call the EBSA help desk at (866) 463-3278.¹¹¹

¹¹⁰ DFVC Notice Sections 5.02, 5.03, 67 Fed. Reg. 60 (March 28, 2002).

¹¹¹ For additional information on the DFVC, see DOL's "Frequently Asked Questions about the Delinquent Filer Voluntary Compliance Program" at http://www.dol.gov/ebsa/faqs/faq_dfvc.html.

Chapter 14

Required Minimum Distributions

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On April 17, 2002, the Internal Revenue Service (IRS) issued the final regulations under Internal Revenue Code (IRC) Section 401(a)(9) for required minimum distributions (RMDs) from retirement plans.¹ The RMD rules apply to qualified plans under IRC Section 401(a), annuity contracts under IRC Section 403(a), individual plans under IRC Sections 408(a)(6) and 408(b)(3), including Roth individual retirement accounts or annuities (IRAs) under IRC Section 408A for certain purposes, and even certain deferred compensation plans under IRC Section 457(d)(2).² This chapter will examine the RMD rules for years after 2002, as they apply to qualified plans and IRAs (including Roth IRAs).

Introduction

RMDs are calculated on an annual basis once one reaches the age of 70½. A retirement plan balance as of December 31 of the prior year is divided by a life expectancy factor to arrive at a distribution amount or RMD for the required distribution year. The life expectancy factor is determined by the age on one's birthday in the required distribution year. Most of the complexity of the RMD rules relates to the complexity of determining the life expectancy factor. The table and the methodology that is used to determine the life expectancy factor depends on whether the plan owner is living or not, whether there is a beneficiary or not, and whether a beneficiary is the spouse or not—and this is coupled with a myriad of special rules and exceptions. It should be noted that the RMD rules relate to minimum amounts that must be distributed. Greater amounts may be distributed if needed without penalty if the plan owner is older than age 59½. If RMDs are not made, the potential penalty for not making the distribution is 50 percent of the RMD that should have been made.³

¹ Treas. Reg. Section 1.401(a)(9).

² Treas. Reg. Section 1.401(a)(9)-1, A-1.

³ IRC Section 4974(a).

Lifetime Required Minimum Distributions

The rules for RMDs during one's lifetime are different than the rules for postdeath distributions.

Required Beginning Date

Generally, the required beginning date is April 1 of the calendar year following the calendar year in which the plan owner attains age 70½.⁴

Example. John was born on May 1, 1934. He will attain age 70 on May 1, 2004, and will be age 70½ on November 1, 2004. His required beginning date is April 1, 2005. Mary was born on July 10, 1934. She will attain age 70 on July 10, 2004, and will be age 70½ on January 10, 2005. Her required beginning date is April 1, 2006. Each must make their first RMD by the required beginning date.

Employment Exception for Plans Other Than IRAs

For plan owners who do not own more than 5 percent of their company, the required beginning date is the later of April 1 of the calendar year following the calendar year in which the plan owner attains age 70½ or April 1 following the year in which the plan owner retires.⁵

“Uniform Lifetime Table”

For most plan owners (other than those falling under the spousal exception), the “Uniform Lifetime Table”⁶ (previously known as the “Minimum Distribution Incidental Benefits or MDIB Table”⁷) is used to find the life expectancy factor (referred to as the distribution period in the table) that is used to determine the RMD. The table will need to be used for each year the plan owner is alive. If the plan owner has a seventieth birthday in the year in which he turns 70½, a 27.4 factor from the “Uniform Life Table” is used for the first RMD year. If the plan owner has a seventy-first birthday in the year in which he turns 70½, a 26.5 factor from the Uniform Life Table is used for the first RMD year.

Example. John was born on May 1, 1934, and will be age 70½ on November 1, 2004. In 2004, he will have a seventieth birthday. His first RMD will be based on a 12/31/2003 plan balance divided by a life expectancy factor of 27.4 (which is the “Uniform Lifetime Table” distribution period value for age 70). Mary was born on July 10, 1934, and will be age 70½ on January 10, 2005. In 2005, she will have a seventy-first birthday. Her first RMD will be based on a 12/31/2004 plan balance divided by a life expectancy factor of 26.5 (which is the “Uniform Lifetime Table” distribution period value for age 71).

Two RMDs in One Year

Since the first RMD does not need to be distributed until the required beginning date of April 1st, it is possible to have two RMDs in one year. Generally, it is not a good idea to take two RMDs in the same year as it may result in moving into a higher income tax bracket. After the first RMD, all RMDs must be distributed during the calendar year. An RMD may be distributed in one amount or in numerous partial amounts as long as the entire RMD amount is distributed during the appropriate time period.

⁴ Treas. Reg. Section 1.401(a)(9)-2, A-2.

⁵ Treas. Reg. Section 1.401(a)(9)-2, A-2(a).

⁶ Treas. Reg. Section 1.401(a)(9)-9, A-2.

⁷ Table of Applicable Divisors for the Minimum Distribution Incidental Benefit Rule in the 1987 Prop. Reg. §1.401(a)(9)-2, Q&A-4(a)(2).

Example. John was born on May 1, 1934, and his required beginning date is April 1, 2005. His first RMD will be based on a 12/31/2003 plan balance divided by a life expectancy factor of 27.4. The first RMD must be distributed any time from January 1, 2004, through April 1, 2005. His second RMD will be based on a 12/31/2004 plan balance divided by a life expectancy factor of 26.5 and must be distributed from January 1, 2005, through December 31, 2005.

Spousal Exception

If the spouse is the sole beneficiary for the entire year and is more than ten years younger than the plan owner, the RMD is the longer of the appropriate factors⁸ from the “Uniform Lifetime Table”⁹ and the “Joint and Last Survivor Table.”¹⁰

Example. John was born on May 1, 1934, and will be age 70½ on November 1, 2004. In 2004, he will have a seventieth birthday. If he is not married, his first RMD would be based on a 12/31/2003 plan balance divided by a life expectancy factor of 27.4 (which is the “Uniform Lifetime Table” distribution period value for age 70). Since his wife and sole beneficiary, Susan, was born on July 10, 1945 (which makes her more than ten years younger than her husband), he may use the longer life expectancy factor of 28.1 from the “Joint and Last Survivor Table.” The joint life expectancy, taken from the joint table for ages 70 and 59, is 28.1.

Roth IRA

Roth IRA owners are not subject to the RMD rules while they are living. They do not have to take distributions after attaining age 70½. However, Roth IRA beneficiaries (owners of inherited Roth IRAs) are subject to the RMD rules. For Roth IRAs, refer to the appropriate sections below for postdeath required distributions if the owner dies before the required beginning date. The Roth IRA final regulations state that the “minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date.”¹¹

Roth 401(k)

Roth 401(k) plans are subject to the same rules as regular IRAs and 401(k) plans which means that Roth 401(k) owners are subject to the lifetime required minimum distribution rules.¹² However, the proposed regulations also refer to a rollover of a Roth 401(k) to a Roth IRA.¹³ Such a rollover would appear to allow a Roth 401(k) owner to avoid the lifetime required minimum distribution rules.

Postdeath Required Distributions

After the death of the plan owner, RMD calculations depend on the type of beneficiary and sometimes on whether the plan owner died before or after the required beginning date. RMD calculations are based on the life expectancy of the designated beneficiary if there is one. The designated beneficiary is determined as of

⁸ Treas. Reg. Section 1.401(a)(9)-5, A-4(b).

⁹ Treas. Reg. Section 1.401(a)(9)-9, A-2.

¹⁰ Treas. Reg. Section 1.401(a)(9)-9, A-3.

¹¹ Treas. Reg. Section 1.408A-6, A-14(b).

¹² Proposed Treas. Reg. REG-152354-04, 70 Fed. Reg. 10062 (3/2/05)

¹³ Proposed Treas. Reg. REG-152354-04, 70 Fed. Reg. 10062 (3/2/05)

September 30 of the calendar year following the plan owner's death.¹⁴ Generally, the designated beneficiary must be a beneficiary as of the date of death and must remain a beneficiary as of September 30 of the calendar year following the plan owner's death. In cases of multiple or contingent beneficiaries, it is possible for qualified disclaimers to be used to remove some of the beneficiaries before the September 30 date.

Postdeath Required Distributions: No Designated Beneficiary

Designated beneficiaries must be individuals. Certain beneficiaries are not considered to be designated beneficiaries. These include an estate, a charity, or beneficiaries of a nonqualifying trust. It is also possible to have no beneficiary. If there is no designated beneficiary, there is no life expectancy for the beneficiary and special rules will apply.

Year of Death. In the year of death, the RMD is calculated as if the owner was still alive. (See the preceding discussion of lifetime RMDs.)¹⁵

Owner Dies Before Required Beginning Date

If the plan owner dies before the required beginning date and there is no designated beneficiary, the five-year rule applies.¹⁶ Under the five-year rule, the entire plan must be distributed by the end of the calendar year that contains the fifth anniversary of the plan owner's date of death.

Example. The plan owner dies on February 1, 2005, with no designated beneficiary. The fifth anniversary of the date of death is February 1, 2010. Therefore, the entire plan balance must be distributed by December 31, 2010.

Owner Dies On or After Required Beginning Date

If the plan owner dies on or after the required beginning date and there is no designated beneficiary, RMDs are taken over a term based on the plan owner's life expectancy in the year of death.¹⁷ The factors used in the RMD calculations are not taken directly from any table, but are based on the life expectancy factor in the "Single Life Table"¹⁸ as of the plan owner's year of death. The "Single Life Table" life expectancy for the year of death is obtained, and one is subtracted for each year after the year of death.¹⁹

Example. John was born on May 1, 1934. His required beginning date is April 1, 2005. He dies on June 30, 2005. In 2005, his life expectancy factor for RMD distributions is 26.5 and is taken from the "Uniform Lifetime Table." In the year he died (2005), his life expectancy factor from the "Single Life Table" was 16.3. In 2006, his life expectancy factor for RMD calculations is 15.3. For future RMD calculations, his life expectancy factor will be 14.3 in 2007, 13.3 in 2008, etc., until it reaches 0.3 in 2021 and the entire plan must be distributed.

¹⁴ Treas. Reg. Section 1.401(a)(9)-4, A-4.

¹⁵ Treas. Reg. Section 1.401(a)(9)-2, A-5.

¹⁶ Treas. Reg. Section 1.401(a)(9)-3, A-4(a)(2).

¹⁷ Treas. Reg. Sections 1.401(a)(9)-5, A-5(a)(2) and 1.401(a)(9)-5, A-5(c)(3).

¹⁸ Treas. Reg. Section 1.401(a)(9)-9, A-1.

¹⁹ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(3).

Roth IRA

It is not relevant whether the Roth IRA owner dies before or after the required beginning date.²⁰ For Roth IRAs, the first RMD must be made by December 31 of the appropriate year. If there is no designated beneficiary, the five-year rule will apply.²¹ Under the five-year rule, the entire plan must be distributed by the end of the calendar year that contains the fifth anniversary of the Roth IRA plan owner's date of death.

Postdeath Required Distributions: Nonspousal Beneficiary

In this case, there is a qualified designated beneficiary who is not the plan owner's spouse. Such individuals may be relatives or nonrelatives or certain qualifying trust beneficiaries.

Year of Death

In the year of death, the RMD is calculated as if the owner was still alive. (See the preceding section entitled "Lifetime Required Minimum Distributions.")²²

Owner Dies Before Required Beginning Date

For a nonspousal beneficiary in cases in which the owner dies before the required beginning date, the distribution period is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year *after the year of the plan owner's death*.²³ The "Single Life Table" is used to determine the life expectancy with future years determined by subtracting one for each calendar year after the calendar year following the calendar year of the plan owner's year of death. This is unlike the case in which there is no designated beneficiary and the plan owner dies on or after the required beginning date. In those cases, the first distribution in the year after the plan owner's date of death is a life expectancy *for the year of death minus one*. If a beneficiary does not take RMDs under the permitted life expectancy method, withdrawals must be made under the five-year rule.²⁴

Example. John, the plan owner, was born on June 1, 1935. He dies on June 30, 2005, which is prior to his required beginning date of April 1, 2006. His designated beneficiary, Robert, was born on May 1, 1934. Robert will have his 72nd birthday in 2006. In 2006, Robert's life expectancy factor from the "Single Life Table" is 15.5. For future RMD calculations, his life expectancy factor will be 14.5 in 2007, 13.5 in 2008, etc., until it reaches 0.5 in 2021 and the entire plan must be distributed.

Owner Dies On or After Required Beginning Date

For a nonspousal beneficiary in cases in which the owner dies on or after the required beginning date, the distribution period is the longer of the beneficiary's life expectancy or the plan owner's life expectancy.²⁵ The beneficiary's life expectancy is the distribution period determined using the beneficiary's age as of the beneficiary's birthday in the calendar year *after the year of the plan owner's death*.²⁶ The "Single Life Table" is used

²⁰ Treas. Reg. Section 1.408A-6, A-14(b).

²¹ Treas. Reg. Section 1.401(a)(9)-3, A-4(a)(2).

²² Treas. Reg. Section 1.401(a)(9)-2, A-5.

²³ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c).

²⁴ Treas. Reg. Section 1.401(a)(9)-3, A-1(a).

²⁵ Treas. Reg. Section 1.401(a)(9)-5, A-5(a)(1).

²⁶ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(1).

to determine the life expectancy with future years determined by subtracting one for each calendar year after the calendar year following the calendar year of the plan owner's year of death. The plan owner's life expectancy is based on the life expectancy factor in the "Single Life Table" for the plan owner's year of death. The "Single Life Table" life expectancy for the year of death is obtained and one is subtracted for each year after the year of death.²⁷ As a practical manner, the beneficiary's life expectancy will be used if the beneficiary is younger than the plan owner. In the more unlikely case in which the beneficiary is older than the plan owner, the plan owner's life expectancy may be greater and would then be the one used.

Example. John, the plan owner, was born on June 1, 1935. He dies on June 30, 2007, which is after his required beginning date of April 1, 2006. His designated beneficiary, Robert, was born on May 1, 1934. Robert will have his 74th birthday in 2008. In 2008, Robert's life expectancy factor from the "Single Life Table" is 14.1. John has a 72nd birthday in 2007. For 2007, John's life expectancy factor from the "Single Life Table" is 15.5. In 2008, John's life expectancy would be 15.5 minus 1, or 14.5. Since 14.5 is longer than 14.1, 14.5 is the life expectancy used for calculating the 2008 RMD. A similar process leads to 13.5 for 2009 until 0.5 is used for 2022.

Roth IRA

It is not relevant whether the Roth IRA owner dies before or after the required beginning date.²⁸ For a non-spousal beneficiary, the distribution period is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year *after the year of the Roth IRA owner's death*.²⁹ The "Single Life Table" is used to determine the life expectancy with future years determined by subtracting one for each calendar year after the calendar year following the calendar year of the Roth IRA owner's year of death. If a beneficiary does not take RMDs under the permitted life expectancy method, withdrawals must be made under the five-year rule.³⁰

Postdeath Required Distributions: Spouse as Beneficiary

There are special rules that apply if the plan owner's sole beneficiary is the surviving spouse. For IRAs, a spouse can optionally elect to treat the plan as one's own (that is, a spousal rollover) rather than remain as the beneficiary. Before looking at the spousal rollover, we will review the distribution rules for when the spouse remains as the beneficiary.

Year of Death

In the year of death, the RMD is calculated as if the owner was still alive. (See the preceding discussion of lifetime RMDs.)³¹

Owner Dies Before Required Beginning Date and Spouse Remains the Beneficiary

For a spousal beneficiary in cases in which the owner dies before the required beginning date, the distribution period is determined using the spouse's age as of the spouse's birthday in the calendar year *after the year of*

²⁷ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(3).

²⁸ Treas. Reg. Section 1.408A-6, A-14(b).

²⁹ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c).

³⁰ Treas. Reg. Section 1.401(a)(9)-3, A-1(a).

³¹ Treas. Reg. Section 1.401(a)(9)-2, A-5.

the plan owner's death. The “Single Life Table” is used with all years taken directly from the table³² (unlike nonspousal beneficiaries who use a value from the table and then subtract one for each future year). However, after the spouse dies, RMDs will be based on the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the year of the spouse's death minus one for each calendar year after the year of the spouse's death.³³ The spouse also has a special rule for when RMDs must start. The first year of distributions will be the later of end of the calendar year following the year in which the plan owner died or the end of the calendar year in which the plan owner would have attained age 70½.³⁴ If a beneficiary does not take RMDs under the permitted life expectancy method, withdrawals must be made under the five-year rule.³⁵

Example. John, the plan owner, was born on May 1, 1944, and would be age 70½ on November 1, 2014, with a required beginning date of April 1, 2015. His wife and sole beneficiary, Susan, was born on June 10, 1950. John dies in 2005 and his wife remains his beneficiary. The first year of distributions is the later of the year after John died, 2006, or the year in which John would have been 70½, or 2014. The first RMD is in 2014 using a “Single Life Table” value of 21.8, which is the life expectancy factor for a person who is 64 (Susan's age in 2014). In 2015, the life expectancy is also taken from the table and is 21.0. If Susan dies in 2037, the life expectancy factor from the table for age 87, or 6.7, is used. In 2038, the life expectancy factor is 6.7 minus 1 or 5.7. The life expectancy factor drops to 0.7 in 2043, at which time the entire plan balance must be distributed.

Owner Dies On or After Required Beginning Date and Spouse Remains the Beneficiary

For a spousal beneficiary in cases where the owner dies after the required beginning date, the distribution period is determined using the spouse's age as of the spouse's birthday in the calendar year *after the year of the plan owner's death*. The “Single Life Table” is used with all years taken directly from the table³⁶ (unlike nonspousal beneficiaries who use a value from the table and then subtract one for each future year) as long as the spouse is living. However, after the spouse dies, RMDs will be based on the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the year of the spouse's death minus one for each calendar year after the year of the spouse's death.³⁷

Example. John, the plan owner, was born on May 1, 1944, and would be age 70½ on November 1, 2014, with a required beginning date of April 1, 2015. His wife and sole beneficiary, Susan, was born on June 10, 1950. John dies in 2016 with John already having started taking RMDs. His wife remains his beneficiary. The RMD calculation in 2016 will use a “Uniform Lifetime Table” value based on John's age of 72 or 25.6. The RMD calculation in 2017 will use a “Single Life Table” value based on Susan's age of 67 in 2017 or 19.4. If Susan dies in 2037, the life expectancy factor from the table for age 87, or 6.7, is used. In 2038, the life expectancy factor is 6.7 minus 1 or 5.7. The life expectancy factor drops to 0.7 in 2043, at which time the entire plan balance must be distributed.

³² Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c)(2).

³³ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(2).

³⁴ Treas. Reg. Section 1.401(a)(9)-3, A-3(b).

³⁵ Treas. Reg. Section 1.401(a)(9)-3, A-1(a).

³⁶ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c)(2).

³⁷ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(2).

Spousal Rollover of IRA

The spouse of a beneficiary may elect to treat the IRA as her own IRA.³⁸ This can be accomplished by directly transferring the IRA to the spouse's IRA or by retitling the IRA in the spouse's name. This may be done any time after the death of original IRA owner and it would be important for the spouse to select beneficiaries. Generally, a spousal rollover is considered to be the best choice rather than remaining as a spousal beneficiary. However, there are several cases in which it may be desirable not perform a spousal rollover. If the surviving spouse is under 59½ years of age and may want to make withdrawals from the IRA before she reaches age 59½, she could avoid the 10 percent penalty for early withdrawals because IRA beneficiaries are not subject to the 10 percent penalty. Also, in cases in which the spousal beneficiary is much older than an IRA owner who was not yet 70½, distributions could be delayed if there is no spousal rollover.

Example. John, an IRA owner, was born on May 1, 1944, and would be age 70½ on November 1, 2014, with a required beginning date of April 1, 2015. His wife and sole beneficiary, Susan, was born on June 10, 1950. They have a son named Jason born on March 1, 1975. John dies in 2016 with John already having started taking RMDs. Rather than remaining as a spousal beneficiary, Susan performs a spousal rollover in 2016 to become the new owner of the IRA and names Jason as the beneficiary. An RMD is required in 2016 using John's age 72, or 25.6, from the "Uniform Lifetime Table." No RMDs are required in 2017, 2018, or 2019. Susan's first RMD is for 2020 (and may be taken as late as April 1, 2021) based on a factor of 27.4 (taken from the "Uniform Lifetime Table" for age 70). If Susan dies in 2037, the life expectancy factor from the table for age 87, or 13.4, is used. In 2038, the life expectancy factor is 22.7 (the "Single Life Table" value for Jason at age 63). In 2039, the factor is reduced by one to 21.7. The life expectancy factor drops to 0.7 in 2060, at which time the entire plan balance must be distributed when Jason is age 85. Had Susan remained as the spousal beneficiary, the entire plan would have been required to be distributed by 2043.

Roth IRA

It is not relevant whether the Roth IRA owner dies before or after the required beginning date.³⁹ For a spousal beneficiary of a Roth IRA, the distribution period is determined using the spouse's age as of the spouse's birthday in the calendar year *after the year of the Roth IRA plan owner's death*. The "Single Life Table" is used with all years taken directly from the table⁴⁰ (unlike nonspousal beneficiaries who use a value from the table and then subtract one for each future year). However, after the spouse dies, RMDs will be based on the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the year of the spouse's death minus one for each calendar year after the year of the spouse's death.⁴¹ The spouse also has a special rule for when RMDs must start. The first year of distributions will be the later of the end of the calendar year following the year in which the plan owner died or the end of the calendar year in which the plan owner would have attained age 70½.⁴² The spouse of a beneficiary may elect to treat the Roth IRA as her own Roth IRA (see the preceding discussion of spousal rollover of an IRA.)⁴³ If a beneficiary does not take RMDs under the permitted life expectancy method, withdrawals must be made under the five-year rule.⁴⁴

³⁸ Treas. Reg. Section 1.408-8, A-5.

³⁹ Treas. Reg. Section 1.408A-6, A-14(b).

⁴⁰ Treas. Reg. Section 1.401(a)(9)-5, A-5(b) and (c)(2).

⁴¹ Treas. Reg. Section 1.401(a)(9)-5, A-5(c)(2).

⁴² Treas. Reg. Section 1.401(a)(9)-3, A-3(b).

⁴³ Treas. Reg. Section 1.408-8, A-5.

⁴⁴ Treas. Reg. Section 1.401(a)(9)-3, A-1(a).

Future Changes to the RMD Rules

Like all areas of the tax law, future changes to the rules for RMDs are likely. Legislative or regulatory changes may occur at any time. The life expectancy tables used for RMD calculations are revised at least every ten years with another revision due by 2012. The NewRMD.com web site at www.newrmd.com is one source of information for legislative proposals and any actual legislative or regulatory changes.

Extracts of Treasury Regulations

Treasury Regulations Section 1.401(a)(9)-9— Life Expectancy and Distribution Period Tables

Q-1. What is the life expectancy for an individual for purposes of determining required minimum distributions under IRC Section 401(a)(9)?

A-1. The following table, referred to as the “Single Life Table,” is used for determining the life expectancy of an individual.

Single Life Table

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	82.4	29	54.3	58	27.0	87	6.7
1	81.6	30	53.3	59	26.1	88	6.3
2	80.6	31	52.4	60	25.2	89	5.9
3	79.7	32	51.4	61	24.4	90	5.5
4	78.7	33	50.4	62	23.5	91	5.2
5	77.7	34	49.4	63	22.7	92	4.9
6	76.7	35	48.5	64	21.8	93	4.6
7	75.8	36	47.5	65	21.0	94	4.3
8	74.8	37	46.5	66	20.2	95	4.1
9	73.8	38	45.6	67	19.4	96	3.8
10	72.8	39	44.6	68	18.6	97	3.6
11	71.8	40	43.6	69	17.8	98	3.4
12	70.8	41	42.7	70	17.0	99	3.1
13	69.9	42	41.7	71	16.3	100	2.9
14	68.9	43	40.7	72	15.5	101	2.7
15	67.9	44	39.8	73	14.8	102	2.5

(continued)

Single Life Table (continued)

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
16	66.9	45	38.8	74	14.1	103	2.3
17	66.0	46	37.9	75	13.4	104	2.1
18	65.0	47	37.0	76	12.7	105	1.9
19	64.0	48	36.0	77	12.1	106	1.7
20	63.0	49	35.1	78	11.4	107	1.5
21	62.1	50	34.2	79	10.8	108	1.4
22	61.1	51	33.3	80	10.2	109	1.2
23	60.1	52	32.3	81	9.7	110	1.1
24	59.1	53	31.4	82	9.1	111+	1.0
25	58.2	54	30.5	83	8.6		
26	57.2	55	29.6	84	8.1		
27	56.2	56	28.7	85	7.6		
28	55.3	57	27.9	86	7.1		

Q-2. What is the applicable distribution period for an individual account for purposes of determining required minimum distributions during an employee's lifetime under section 401(a)(9)?

A-2. The following table, referred to as the "Uniform Lifetime Table," is used for determining the distribution period for lifetime distributions to an employee in situations in which the employee's spouse is either not the sole designated beneficiary or is the sole designated beneficiary but is not more than 10 years younger than the employee.

Uniform Lifetime Table

Age of Employee	Distribution Period	Age of Employee	Distribution Period
70	27.4	92	10.2
71	26.5	93	9.6
72	25.6	94	9.1
73	24.7	95	8.6
74	23.8	96	8.1
75	22.9	97	7.6
76	22.0	98	7.1
77	21.2	99	6.7

Uniform Lifetime Table (continued)

Age of Employee	Distribution Period	Age of Employee	Distribution Period
78	20.3	100	6.3
79	19.5	101	5.9
80	18.7	102	5.5
81	17.9	103	5.2
82	17.1	104	4.9
83	16.3	105	4.5
84	15.5	106	4.2
85	14.8	107	3.9
86	14.1	108	3.7
87	13.4	109	3.4
88	12.7	110	3.1
89	12.0	111	2.9
90	11.4	112	2.6
91	10.8	113	2.4
92	10.2	114	2.1
93	9.6	115+	1.9

Final Roth IRA Regulations Pertaining to Minimum Distributions

Treasury Regulations Section 1.408A-6—Distributions

Q-14. What minimum distribution rules apply to a Roth IRA?

A-14. There are three aspects to the minimum distribution rules that apply to a Roth IRA:

1. No minimum distributions are required to be made from a Roth IRA under IRC Sections 408(a)(6) and (b)(3), which generally incorporate the provisions of IRC Section 401(a)(9), while the owner is alive. The postdeath minimum distribution rules under IRS Section 401(a)(9)(B) that apply to traditional IRAs, with the exception of the at-least-as-rapidly rule described in IRC Section 401(a)(9)(B)(i), also apply to Roth IRAs.
2. The minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date. Thus, generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless the interest is payable to a designated beneficiary over a period not greater than that beneficiary's life expectancy and distribution commences before the end of the calendar year following the year of death. If the sole beneficiary is the decedent's spouse, such spouse may delay distributions until the decedent would have attained age 70½ or may treat the Roth IRA as his or her own.

3. Distributions to a beneficiary that are not qualified distributions will be includible in the beneficiary's gross income according to the rules in A-4 of this section.

Q-15. Does IRC Section 401(a)(9) apply separately to Roth IRAs and individual retirement plans that are not Roth IRAs?

A-15. Yes. An individual required to receive minimum distributions from his or her own traditional or SIMPLE IRA cannot choose to take the amount of the minimum distributions from any Roth IRA. Similarly, an individual required to receive minimum distributions from a Roth IRA cannot choose to take the amount of the minimum distributions from a traditional or SIMPLE IRA. In addition, an individual required to receive minimum distributions as a beneficiary under a Roth IRA can only satisfy the minimum distributions for one Roth IRA by distributing from another Roth IRA if the Roth IRAs were inherited from the same decedent.⁴⁵

⁴⁵ CFR, Title 26, Volume 5, Revised as of April 1, 2002. 26CFR1.408A-6 [Page 461-467]. www.access.gpo.gov/nara/cfr/waisidx_02/26cfr1v5_02.html.

Chapter 15

Taxation of Retirement Plan Distributions

The federal tax rules applicable to pre- and postretirement distributions from qualified and nonqualified plans of deferred compensation are discussed in this chapter. The 10-year forward tax-averaging method for individuals born before 1936, the 20 percent capital gains treatment with respect to pre-1974 participation, and the exclusion of net unrealized appreciation in distributed employer securities are discussed in this chapter. The premature distribution penalty tax and exceptions from the penalty tax are also discussed. Required minimum distributions (RMDs) are discussed in Chapter 14, "Required Minimum Distributions." Nonqualified deferred compensation plans are discussed in Chapter 26, "Nonqualified Deferred Compensation."

IRA-Based Plans

SIMPLE IRA Distributions

In general, all distributions (including gain) from a savings incentive match plan for employees, individual retirement accounts or annuities (SIMPLE IRA) are taxable as ordinary income when withdrawn from the SIMPLE IRA and are taxed as ordinary income. The same rules that apply to traditional IRAs also apply to SIMPLE IRAs. If distributions are before age 59½, the amount received may also be subject to a 10 percent or 25 percent penalty.¹ A special rule applies to a payment or distribution received from a SIMPLE IRA during the two-year period beginning on the date on which the individual first participated in the SIMPLE IRA plan (the two-year period). If the penalty tax on early distributions applies to a distribution within the two-year period, the tax increases from 10 percent to 25 percent.² If another exception to the penalty tax applies (see below), neither the 10 nor 25 percent penalty taxes apply. The RMD rules apply to SIMPLE IRAs.

The trustee or custodian is required to report distribution amounts to the IRS on Form 1099-R and to provide a copy of the form to the owner of the SIMPLE IRA. The usual IRA withholding rules apply.

SEP IRA Distributions

In general, all distributions (including gain) from a simplified employee pension plan (SEP) IRA are taxable when withdrawn from the SEP IRA and are taxed as ordinary income. Distributions of SEP contributions (including gain) are taxed in the same manner as traditional IRA distributions. Distributions are subject to

¹ Internal Revenue Code (IRC or the Code) Section 72(t), 408(d)(1), 408(p)(1).

² IRC Section 72(t)(6).

federal income tax except to the extent of any basis attributable to nondeductible contributions. Distributions made prior to age 59½ may be subject to a 10 percent premature distribution penalty tax unless an exception applies. Other rules may apply to salary-reduction or elective SEP (SARSEP) distributions and the removal of excess contributions. The RMD rules apply to SEP IRAs.

Recognizing Losses in an IRA

If there is an investment loss in a traditional IRA or SIMPLE IRA, the loss can be recognized (included) on the federal income tax return, but only when all assets in all traditional IRA accounts and SIMPLE IRA accounts have been fully distributed and the total distributed is less than the unrecovered basis, if any.³ The basis in an IRA is the total amount of the nondeductible contributions made to all traditional and SIMPLE IRAs. The loss is claimed as a miscellaneous itemized deduction, subject to the 2 percent of adjusted gross income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040.

Example. Scotty has made nondeductible contributions to a traditional IRA totaling \$2,000, giving him a basis at the end of 2007 of \$2,000. By the end of 2008, his IRA earns \$400 in interest income. In that year, Scotty receives a distribution of \$600 (\$500 basis + \$100 ($\$600 - (\$2,000 / \$2,400 \times \$600)$) interest), reducing the value of his IRA to \$1,800 ($\$2,000 + \$400 - \600) at year's end. In 2009, Scotty's IRA has a loss of \$500. At the end of that year, Scotty's IRA balance is \$1,300 ($\$1,800 - 500$). Scotty's remaining basis in his IRA is \$1,500 ($\$2,000 - 500$). Scotty receives the \$1,300 balance remaining in the IRA. He can claim a loss for 2009 of \$200 (the \$1,500 basis minus the \$1,300 distribution of the IRA balance).

Note. Basis in a traditional IRA could potentially be attributable to a distribution that actually came from a SIMPLE IRA plan account. The rules for determining the pro-rata amount compare the basis in all traditional IRAs versus the balance in all traditional IRAs, including both SEP IRAs and SIMPLE IRA plan accounts. Thus, theoretically, a distribution from a SIMPLE could include basis, even though no after-tax monies were ever contributed to the SIMPLE,⁴ assuming there was basis from nondeductible contributions and/or a rollover of after-tax monies to a traditional IRA account.

Example. Worf made nondeductible contributions to a traditional IRA totaling \$2,000 in earlier years, giving him a basis at the end of 2007 of \$2,000. (Assume no gain.) Worf's employer maintains a SIMPLE IRA into which \$4,000 has been contributed; he withdraws \$1,000 on December 31, 2007, from the SIMPLE IRA, leaving a balance in the SIMPLE IRA of \$3,000. \$333.33 of the \$1,000 distributed from the SIMPLE IRA is treated as a return of basis (attributable to the traditional IRA). Thus, only \$666.67 is taxable ($\$1,000 - (\$2,000 / (\$2,000 + \$3,000 + \$1,000) \times \$1,000)$). Worf's remaining basis in the traditional IRA is now \$1,666.67 ($\$2,000 - \333.33). In 2008, Worf withdraws \$5,000 from the remaining amount in all of his IRA-based accounts. Again, assume no gain. He will have to report \$3,333.33 ($\$5,000 - \$1,666.67$) as taxable income.

³ Roth IRAs have separate basis recovery rules, but the method of computing a loss is the same. Form 8606 is correct (line 6 includes the value of "all...traditional, SEP, and Simple IRAs"), however, Publication 590 (for 2006, page 40) regarding loss recognition is poorly worded, especially in light of the definition of a traditional IRA on page 7, which states that a "traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA." In a Roth IRA, basis is total amount of the contributions made to the Roth IRA.

⁴ *Id.*

Exclusion for Qualified Health Insurance Premiums

For distributions in taxable years beginning after 2006, there is an exclusion from gross income for distributions from an “eligible government plan” (as defined below) used to pay qualified health insurance premiums of an eligible retired public safety officer.⁵

The aggregate amount that is permitted to be excluded, with respect to any taxable year, from an eligible retired public safety officer’s gross income by reason of Code Section 402(l) is limited to \$3,000. For purposes of applying this \$3,000 limitation, distributions with respect to the eligible retired public safety officer that are used to pay for qualified health insurance premiums from all eligible government plans are aggregated.

The exclusion applies with respect to an eligible retired public safety officer who elects to have qualified health insurance premiums deducted from amounts distributed from an eligible government plan and paid directly to the insurer. Qualified health insurance premiums include premiums for accident and health insurance or qualified long-term care insurance contracts for the eligible retired public safety officer and his or her spouse and dependents. The accident or health plan must be an accident or health insurance plan issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance). The distribution is excluded from gross income to the extent that the aggregate amount of the distributions does not exceed the amount used to pay the qualified health insurance premiums of the eligible retired public safety officer and his or her spouse and dependents. An *eligible government plan* is a governmental plan described in Code Section 414(d) that is either: a qualified plan under Codes Section 401(a), 403(a), or 403(b) plan; or an eligible governmental plan under Code Section 457(b).⁶

An eligible retired public safety officer for purposes of the exclusion is an eligible retired public safety officer who separated from service, either by reason of disability or after attainment of normal retirement age, as a public safety officer with the employer who maintains the eligible government plan from which the distributions to pay qualified health insurance premiums are made. Thus, a public safety officer who retires before attainment of normal retirement age is not an eligible retired public safety officer unless the public safety officer retires by reason of disability. The terms of the eligible government plan from which the participant receives the distribution(s) apply in determining whether a public safety officer has separated from service by reason of disability or after attainment of normal retirement age.

For purposes of the exclusion, the term *public safety officer* means an individual serving a public agency in an official capacity, with or without compensation, as a law enforcement officer, a firefighter, a chaplain, or as a member of a rescue or ambulance crew.⁷

Note. If an eligible retired public safety officer dies, amounts subtracted from distributions made to the decedent’s surviving spouse or dependents are not eligible for the exclusion. Code Section 402(l) provides that the distribution is not includible in the gross income of an *employee* who is an eligible retired public safety officer. Thus, the exclusion would not extend to amounts subtracted from distributions to other distributees.

Note. Amounts used to pay qualified health insurance premiums that are excluded from gross income under Code Section 402(l) are not taken into account for purposes of determining the itemized deduction for medical care expenses under Code Section 213.

⁵ IRC Section 402(l), added by PPA ‘06, Section 845(a).

⁶ See, generally, IRS Notice 2007-7, Part VI, 2007-5 IRB 395 (January 29, 2007).

⁷ See Section 1204(9)(A) of the Omnibus Crime Control and Safe Streets Act of 1968 (42 U.S.C. 3796b(9)(A)).

457 Plan Distributions

Eligible Governmental 457 Plan

For distributions made after December 31, 2001, amounts deferred under an eligible Internal Revenue Code (IRC or the Code) Section 457 (governmental 457 plan), and any income attributable to such amounts, are includable in the participant's gross income for the taxable year in which they are paid to the participant or the participant's beneficiary.⁸ The RMD rules apply to 457 plans.

Note. For distributions made before January 1, 2002, from such plans, any amounts deferred under an eligible 457 plan (and any income attributable thereto) were includable in the participant's gross income for the taxable year in which paid or otherwise made available to the participant (or beneficiary).⁹

Eligible Nongovernmental 457 Plans

Distributions of amounts deferred under eligible 457 plans sponsored by nongovernmental tax-exempt organizations are includable in the participant's gross income for the taxable year in which they are made available to the participant or the participant's beneficiary, without regard to whether they have actually been distributed.¹⁰ Such amounts are not considered to be available simply because the participant or beneficiary is permitted to choose among various investments for amounts deferred under the plan.¹¹ The use of a rabbi trust should not affect the tax treatment of participants or their beneficiaries.¹²

Ineligible 457 Plans

Compensation deferred under an ineligible 457 plan generally is includable in gross income in the first taxable year during which it is not subject to a "substantial risk of forfeiture."¹³ If no substantial risk of forfeiture exists in the initial year of deferral, all compensation deferred under the plan must be included in the participant's gross income for that year. The use of a rabbi trust plan does not affect the tax treatment of amounts deferred under an ineligible 457 plan.¹⁴

A participant's right to deferred compensation under an ineligible 457 plan is subject to a substantial risk of forfeiture if it is conditioned on the future performance of substantial services by any individual.¹⁵ Distributions from an ineligible plan are taxed according to the annuity rules.¹⁶

If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants will be includable in income when deferred, or, if later, when the amounts deferred cease to be subject to a substantial risk of forfeiture. Amounts deferred before the date on which the plan ceases to be an eligible governmental plan, and any earnings thereon, will be treated as if the plan continues to be an eligible governmental plan and, thus, will not be includable in income until paid to the participant or beneficiary.¹⁷

⁸ IRC Section 457(a)(1)(A); Treas. Reg. Section 1.457-7(b)(1).

⁹ IRC Section 457(a), prior to amendment by EGTRRA 2001; See Ltr. Rul. 9443015.

¹⁰ IRC Section 457(a)(1)(B); Treas. Reg. Section 1.457-7(c)(1).

¹¹ Treas. Reg. Section 1.457-7(c)(1).

¹² See, Ltr. Ruls. 9517026, 9436015.

¹³ IRC Section 457(f)(1)(A); Treas. Reg. Section 1.457-11(a)(1).

¹⁴ See, Ltr. Ruls. 200009051, 9713014, 9701024, 9444028, 9430013, 9422038.

¹⁵ IRC Section 457(f)(3)(B); Treas. Reg. Section 1.83-3(c).

¹⁶ IRC Section 457(f)(1)(B); Treas. Reg. Section 1.457-11(a)(4).

¹⁷ Treas. Reg. Section 1.457-9.

Premature Distributions

The 10 percent premature distribution tax may apply to rollovers (by direct transfer) from other plan types that are later distributed under the 457 plan.

Tax-Sheltered Annuities

Payments received are taxable to the employee, except to the extent the amounts are a recovery of the employee's investment in the contract or to the extent the employee rolls over an eligible distribution to another tax sheltered annuity, a qualified plan, an eligible governmental 457 plan, or a traditional IRA. In general, if an annuity contract without life insurance protection is used for funding plan benefits, all payments received are normally taxable in full as ordinary income to the employee.¹⁸ The 10 percent premature distribution tax may apply if the individual is under age 59½, unless an exception applies.

If the IRC Section 403(b) annuity contract or custodial account is solely liable for the payment of investment expenses, the direct payment of investment adviser fees from a participant's annuity or account is not treated as a distribution. (See Letter Rulings 9332040, 9316042, 9047073, and 9845003.)

Excess Contributions to Custodial Accounts

Contributions to a custodial account for the purchase of regulated investment company stock (mutual funds) may be subject to a 6 percent tax (not to exceed 6 percent of the value of the account) if the contribution limits are exceeded. This penalty does not apply to a 403(b) plan funded with annuity contracts or to excess elective deferrals. The plan participant is liable for this tax. The tax is reported on Form 5329.¹⁹

The 6 percent excise tax is paid each year in which there are excess contributions. Excess contributions can be corrected by contributing less than the applicable limit in later years or by making permissible distributions. The individual may not claim a deduction for the excise tax.

Premature Distributions

If an individual receives a premature distribution from a tax-sheltered annuity, his or her tax will be increased by 10 percent of the portion of the distribution includable in income.²⁰

Qualified Plans

Distributions to participants are taxed as ordinary income when received, with the exception of the return of the principal amount of nondeductible voluntary employee contributions.²¹ There are certain situations, however, in which the participant may be eligible for favorable tax treatment. If a distribution or distributions are received from a qualified plan in the form of a lump-sum distribution, and no portion of which is rolled over to an IRA, special tax treatment may include:

¹⁸ IRC Section 403(b)(1).

¹⁹ IRC Section 4973(a)(5), 4973(c)

²⁰ IRC Section 72(t).

²¹ IRC Section 402(a).

- A 20 percent capital gains treatment with respect to pre-1974 participation²²
- The 10-year forward tax averaging for individuals born before 1936²³
- The exclusion of net unrealized appreciation in distributed employer securities discussed²⁴

Life Insurance Protection

The cost of life insurance protection provided under a qualified pension, annuity, or profit-sharing plan must be included in the employee's gross income for the year in which deductible employer contributions or trust income is applied to purchase life insurance protection.²⁵ It does not matter whether the insurance is provided under group permanent or individual cash value life insurance policies or term insurance, and whether it is provided under a trustee or nontrustee plan.²⁶

Lump-Sum Distributions From Qualified Plans

Favorable tax treatment is available only to participants and beneficiaries who receive a lump-sum distribution from qualified plans. A lump-sum distribution is a distribution within one taxable year of the entire balance to the credit of the individual from all plans of the same type and the distribution is received due to one of the following:²⁷

1. The participant's death
2. Disability (applies only to self-employed individuals²⁸)
3. Separation of service (does not apply to self-employed individuals)
4. The participant attaining age 59½

Lump-sum treatment is not available to a participant who receives periodic payments and subsequently receives a single-sum payment. Form 4972-*Tax on Lump Sum Distributions* is used to figure the tax on a qualified lump sum distribution using the 20 percent capital gain election, the 10-year "forward" averaging tax option, or both.

Death Of Participant

If a qualifying lump sum distribution is made to a beneficiary after the participant's death, the participant must have been born before January 2, 1936, for the beneficiary to elect 10-year forward income averaging or to make the 20 percent capital gains election (discussed below).

Nonqualifying Distributions

The following distributions are not qualified lump-sum distributions and do not qualify for the 20 percent capital gain election or the 10-year tax option:

²² Tax Reform Act of 1986 (TRA 86), Section 1122(h)(3).

²³ TRA 86, Section 1122(h)(5); Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88), Section 1011A(b)(15)(B).

²⁴ IRC Sections 402(e)(4).

²⁵ IRC Section 72(m)(3)(B); Treas. Reg. Section 1.72-16(b).

²⁶ Treas. Reg. Sections 1.402(a)-1(a)(3), 1.403(a)-1(d).

²⁷ IRC Section 402(e)(4)(D).

²⁸ See IRC Section 401(c)(1).

1. A distribution that is partially rolled over to another qualified plan or an IRA.
2. Any distribution, if an earlier election to use either the 5- or 10-year tax option had been made after 1986 for the same plan participant. 5-year averaging is no longer available.
3. U.S. Retirement Plan Bonds distributed with the lump sum.
4. A distribution made during the first 5 tax years that the participant was in the plan, unless it was paid because the participant died.
5. The current actuarial value of any annuity contract included in the lump sum (Form 1099-R, box 8, should show this amount, which is used only to figure tax on the ordinary income part of the distribution).
6. A distribution to a 5 percent owner that is subject to penalties under Code Section 72(m)(5)(A) regarding distributions to 5 percent owners that exceed the plan formula.
7. A distribution from an IRA-based plan.
8. A distribution from a 403(b) tax-sheltered annuity.
9. A distribution from a qualified plan if the participant or his or her surviving spouse previously received an eligible rollover distribution from the *same* plan (or another plan of the employer that must be combined with that plan for the lump-sum distribution rules) and the previous distribution was rolled over tax free to another qualified plan or an IRA.
10. A distribution from a qualified plan that received a rollover after 2001 from an IRA (other than a conduit IRA), a governmental section 457 plan, or a section 403(b) tax-sheltered annuity on behalf of the plan participant.
11. A distribution from a qualified plan that received a rollover after 2001 from another qualified plan on behalf of that plan participant's surviving spouse.
12. A corrective distribution of excess deferrals, excess contributions, excess aggregate contributions, or excess annual additions.
13. A lump-sum credit or payment from the Federal Civil Service Retirement System (or the Federal Employees' Retirement System).
14. A distribution of the redemption proceeds of bonds rolled over tax free to a qualified pension plan, etc., from a qualified bond purchase plan.
15. A qualified hurricane distribution.²⁹

Alternate Payee Under a Qualified Domestic Relations Order

Amounts paid to an alternate payee who is a spouse or former spouse pursuant to a qualified domestic relations order (QDRO) is eligible for lump-sum treatment so long as such alternate payee receives the balance to his or her credit under the plan and such amount is received within one taxable year.³⁰

A spouse or former spouse of a plan participant who was born before January 2, 1936, who receives a qualified lump-sum distribution as an alternate payee under a qualified domestic relations order, may make the 20 percent capital gain election and use the 10-year tax option to figure his or her tax on the distribution.

²⁹ Form 8915

³⁰ IRC Section 402(e)(4)(D)(vii).

Tax Credit ESOPs

The Economic Recovery Tax Act of 1981 (ERTA) replaced the TRASOP with the PAYSOP. The PAYSOP was repealed by the Tax Reform Act of 1986 (TRA 86) for compensation paid or accrued after December 31, 1986.

Plan Types

The aggregation of similar plans applies in determining whether or not a lump-sum distribution exists. The three classes of qualified plans for this purpose are pension plans, profit-sharing and stock bonus plans.³¹

Following is a chart of similar plans for this aggregation rule:

All Pension Plans	All Profit-Sharing Plans	All Stock Bonus Plans
All Defined Benefit Plans, and Money-Purchase Pension and Target-Benefit Defined-Contribution Plans	Profit-Sharing, Thrift Incentive, and 401(k) Plans	Employee Stock Ownership Plans,

“Separation From Service” Versus “Severance From Employment”

There is a difference between a “separation from service” for purposes of lump-sum distribution treatment and a “severance from employment” that is required prior to receiving a distribution from a qualified pension plan.³² A pension plan (money-purchase and defined benefit) may be disqualified if it permits distributions prior to “severance from employment” (retirement, disability, and death).³³ For tax purposes, one of the lump-sum distribution treatment events requires a “separation from service.” For example, in order for a 45-year-old participant, who is not disabled, to elect 10-year averaging, he or she must be “separated from service.”

Severance From Employment (for Purposes of a Distributable Event)

A *severance from employment* is made on the basis of whether or not the employee *continues to be employed* by the employer maintaining the plan. Furthermore, note the following:

- All employers required to be aggregated under the controlled group and affiliated service group rules are considered as one employer.³⁴
- If a new employer (not part of a controlled group or affiliated service group) either maintained a qualified plan and employees of the prior employer transfer assets from the prior plan, the employee does not incur a “severance from employment.”
- If the new or successor employer decides to maintain the prior employer’s plan, all employees are treated as not having incurred a “severance from employment,” even if such new employer is not required to be aggregated under the controlled group rules.

³¹ IRC Section 402(e)(4)(D).

³² GCM 39824 (Aug. 27, 1990).

³³ Treas. Reg. Section 1.401-1(b)(1)(i).

³⁴ IRC Sections 414(b), (c), and (m). See, too, 414(o).

- No severance of employment occurs when a new employer is substituted as the sponsor of the former employer's plan, and each participant immediately after the transfer is entitled to a benefit equal or greater than the benefit he would have been entitled to before the transfer.
- If a parent company sells the stock of a subsidiary, resulting in loss of control, a "severance from employment" may occur if:
 - The pension plan continues to be maintained by the parent and not by the subsidiary's new owner.
 - No assets or liabilities are transferred to the new owners of the subsidiary (including all employers required to be aggregated under the controlled group and affiliated service group rules).
 - The new owner of the subsidiary is not required to be aggregated under the controlled group or affiliated service group rules.

Separation From Service (for Purposes of a Lump-Sum Distribution)

A *separation from service* is made on the basis of whether or not the employees continue to work on the same job for a different employer as a result of liquidation, merger, or consolidation. The definition of *employer* in making this determination does not include employers required to be aggregated under the controlled group and affiliated service group rules.

Generally separation from service includes a distribution upon the employee's:

1. Death,
2. Retirement, or
3. Resignation or discharge.

Caution: *A recipient of a total distribution may satisfy the "severance from employment" definition, which will entitle them to receive their distribution, but unless the distribution is made on account of "separation from service," it may not be eligible for favorable tax treatment, unless the age 59½, death, or disability requirement is satisfied.*

Capital Gains Treatment

An individual may be eligible for the flat 20 percent capital gains tax if he or she was a participant in the plan making the distribution prior to 1974. Under certain circumstances, service from a predecessor plan may be included.³⁵ The portion of the distribution eligible for capital gains treatment are those amounts attributable to employer contributions made before January 1, 1974. An individual may elect to treat the capital gain portion as ordinary income.³⁶

The capital gain portion of the distribution is computed by separating the distribution amount into two portions, namely, the ordinary income portion and the capital gains portion. The following calculations are used:

³⁵ Ltr. Rul. 8004092 (Oct 31, 1979). When a partnership incorporated, the profit-sharing Keogh plan was discontinued and a pension plan was started. Ex-partners could aggregate their years of participation in the plans for purposes of ten-year averaging treatment.

³⁶ IRC Section 402(e)(4)(B).

$$\text{Ordinary income} = \frac{\text{total taxable amount} \times \text{months of plan participation after 1973}}{\text{total months of plan participation}}$$

$$\text{Capital gains} = \frac{\text{total taxable amount} \times \text{months of plan participation before 1974}}{\text{total months of plan participation}}$$

For purposes of determining months of participation, any portion of a year before 1974 counts as 12 months, and any portion of a month after 1973 counts as a full month. Form 4972, which must be completed for 10-year averaging, contains an explanation of this calculation. See following example.

Example. Maurie, a calendar year taxpayer aged 59½, separates from the service of his employer, the Motor Corporation, on October 31, 1976. On December 15, 1976, Maurie receives a distribution of the balance to his credit under the Motor Corporation qualified profit sharing plan. Maurie has been an active participant in the plan since January 1, 1971. The distribution is a lump sum distribution within the meaning of Code Section 402(e)(4)(A) which satisfies the requirements of Code Section 402(e)(4)(C), relating to the aggregation of certain trusts and plans, and Code Section 402(e)(4)(H), relating to a minimum period of participation in the plan.

Maury elects to treat the capital gain portion as ordinary income. Thus, all years of his active participation in all plans in which Maurie has been an active participant are treated as years of active participation after December 31, 1973. Accordingly, no portion of the distribution is taxable as long term capital gain under Code Section 402(a)(2), and the total taxable amount of the distribution is "ordinary income" for purposes of Code Section 402(e). Maurie also makes the Code Section 402(e)(4)(B) election for his taxable year in which he receives the distribution. Accordingly, the total taxable amount of the distribution is taxable under the 10-year averaging provisions of section 402(e) (the separate tax).

Ten-Year Forward Income Averaging

If a participant born before 1936³⁷ receives a lump-sum distribution and has been in the plan for five years preceding the year of the lump-sum distribution and is age 59½ or older, he or she may elect to use 10-year averaging on the distribution. Only one such election may be made after age 59½, and an election must apply to all lump-sum distributions received in the same year.

Under the 10-year forward income averaging rules, the amount is treated as if it were spread out over 10 years. The tax equals 10 times the tax on one-tenth of the total taxable amount reduced by the minimum distribution allowance.³⁸ The election is made by Filing Form 4972 as part of the taxpayer's income tax return or amended return for the taxable year.³⁹

³⁷ TRA 86 repealed the 10-year averaging method, however, for participants who attained age 50 before January 1, 1986, 10-year averaging may still be used. See IRC Section 402(e) prior to repeal.

³⁸ The 1986 tax rates are used. The tax is computed taking into account the prior law zero-bracket amount. The minimum distribution allowance is the lesser of (a) \$10,000, or (b) 50 percent of the total taxable amount. The total taxable amount is the employee's cost basis, reduced by distributions previously excludible from gross income. However, the allowance must be reduced by 20 percent of the total taxable amount in excess of \$20,000. Thus, if the total taxable amount is \$70,000 or more, the minimum exclusion allowance is zero.

³⁹ Temp. Reg. Section 11.402(e)(4)(B)-1.

One Election After 1986

After 1986, 10-year income averaging may be elected only once for each plan participant. If the same participant receives more than one lump-sum distribution in 1 tax year, all distributions must be treated in the same way (for example, combined on a single Form 4972).

An election can be made as a beneficiary of a deceased participant and does not affect any election the individual can make for qualified lump-sum distributions from his or her own plan. An election as the beneficiary of more than one qualifying person is also permitted.

Example. Mom and Dad died and each was born before January 2, 1936. Each had a qualified plan of which Son is the beneficiary. Son also received a qualified lump-sum distribution from his own plan and he was also born before January 2, 1936. Son can make an election for each of the distributions; one for himself, one as his mother's beneficiary, and one as his father's. It does not matter if the distributions all occur in the same year or in different years. Separate Form 4972s are filed for each participant's distribution.

Note. An earlier election on Form 4972 or Form 5544 for a distribution before 1987 does not prevent you from making an election for a distribution after 1986 for the same participant, provided the participant was under age 59½ at the time of the pre-1987 distribution.

The purpose of the following chart is to show the tax attributable to distributions from qualified plans that qualify as a lump-sum distribution. The tax rates indicated on this chart do not apply to SEPs, SARSEPs, IRAs, or SIMPLEs, which are generally taxable at the recipient's individual income tax rate of between 10 percent and 35 percent for 2007.

Lump-Sum Distribution*	If Born Before 1936; the 1986 10-Year-Tax	Effective Percentage Rate
\$10,000	\$550	5.5
15,000	830	5.5
20,000	1,100	5.5
25,000	1,801	7.2
30,000	2,521	8.4
35,000	3,347	9.6
40,000	4,187	10.5
45,000	5,027	11.2
50,000	5,874	11.8
60,000	7,674	12.8
70,000	9,505	13.6
75,000	10,305	13.7

(continued)

(continued)

Lump-Sum Distribution*	If Born Before 1936; the 1986 10-Year-Tax	Effective Percentage Rate
80,000	11,105	13.9
90,000	12,705	14.1
100,000	14,471	14.5
125,000	19,183	15.3
150,000	24,570	16.4
175,000	30,422	17.4
200,000	36,922	18.5
250,000	50,770	20.3
300,000	66,330	22.1
350,000	83,602	23.9
400,000	102,602	25.7
450,000	122,682	27.3
500,000	143,682	28.7
550,000	164,682	29.9
600,000	187,368	31.2
650,000	211,368	32.5
700,000	235,368	33.6
750,000	259,368	34.6
800,000	283,368	35.4
850,000	307,368	36.2
900,000	332,210	36.9
950,000	357,210	37.6
1,000,000	382,210	38.2
2,000,000	882,210	44.1

* The portion of a qualifying lump-sum distribution attributable to pre-1974 plan participation is eligible for a special capital gains rate of 20 percent in addition to the election to utilize the 10-year special averaging method of taxation for lump-sum distributions. The 1986 tax-rates are used and take into account the zero bracket amount under prior law.

Note. Five-year averaging repealed for years beginning after 1999.

Beneficiary(ies) Receiving Lump-Sum Distributions

A beneficiary who receives a lump-sum distribution may use capital gains treatment, or 10-year averaging under the same rules as the participant.⁴⁰ The benefits under the participant's plan will generally be included in the participant's federal taxable estate, with the exception of amounts paid to the surviving spouse under the unlimited marital exclusion.

Distributions made before a total distribution (for example, periodic payments made to an employee after retirement) will not preclude lump-sum treatment to a beneficiary after the participant dies. Lump-sum treatment may also be elected by a beneficiary of more than one qualifying decedent.

Lump-Sum Distributions to Multiple Recipients

If a lump-sum distribution from a qualified plan is divided between more than one recipient and when not all recipients are trusts, each individual, estate, or trust can separately elect capital gain treatment and 5- and 10-year averaging. In this case, a recipient figures the tax attributable to his or her percentage of the distribution in accordance with the instructions in Form 4972 for multiple recipients. A recipient can make the election even though the other recipients do not.

If Form 4972 is filed for a trust that shared the distribution only with other trusts, the tax is figured on the whole lump sum first. The trusts then share the tax in the same proportion that they shared the distribution.

Net Unrealized Appreciation in Employer Securities

If securities of the employer corporation are included in a lump-sum distribution, the net unrealized appreciation (NUA) in those securities is not subject to tax. The NUA is ordinarily excluded from any of the tax calculations that may apply to the lump-sum distribution. However, the recipient may elect to have the NUA included in gross income for the year of the distribution. The election may be made simply by including the NUA on the return for the year of the distribution.

In general, NUA in employer securities is the difference between the fair market value (FMV) of the employer securities on the date of distribution and the cost or other basis of the stock. *Securities* includes the employer corporation's stock, bonds, registered debentures, and debentures with interest coupons attached. This term also includes securities of a parent or subsidiary corporation of the employer corporation.

In determining the total NUA, the cost basis is computed by the plan on a per share basis. In the case of a lump-sum distribution (without regard to the five-year participation requirement), all NUA in employer securities is excluded from the distributees' gross income until the employer securities are subsequently sold. In the case of a distribution which is not a lump-sum distribution, the portion of NUA in employer securities, which is attributable to employee contributions only, is excluded from the gross income of the distributee until those employer securities are subsequently sold.

The NUA (determined at the time of distribution) will be taxed at the long-term capital gains rate upon the subsequent sale, regardless of the length of time such securities were held by the employer's plan or the time held by the individual. However, any additional gains on the employer securities upon subsequent sale would be taxed at either the short- or long-term capital gains rate depending upon the actual holding period by the individual from the time the securities were distributed.

⁴⁰ The \$5,000 death benefit exclusion was eliminated for decedents dying after August 20, 1996.

Although the plan's cost basis for purposes of determining the NUA may be composed of varying costs of shares purchased in different years, the shares distributed have a new basis which is the same for each share received in the distribution. This new basis would be used for purposes of determining gain or loss on a subsequent sale or other taxable disposition.⁴¹

If an election is made to include NUA in current income, part of the NUA amount shown in Box 6 of Form 1099-R qualifies for capital gain treatment if there is an amount eligible for capital gain treatment shown in Box 3 of Form 1099-R. The 1099-R instructions include an NUA Worksheet for individuals who make the capital gain and NUA elections.

If a capital-gain election is not made but an election is made to include NUA in current income, the amount of the NUA shown in Box 6 of Form 1099-R is added to the amount from Box 2 of Form 1099-R, and the total amount is taxed as ordinary income under the 10-year averaging method.⁴²

Example. Paolo became an active participant in the Quark Corporation's pension plan on December 11, 1966, and continued to work until March 10, 1995, at which time he retired at age 62. In 2007 he received a lump-sum distribution of \$205,000, consisting of \$40,000 in employer stock having a cost basis of \$20,000 and \$165,000 in cash. Paolo contributed \$10,000 as nondeductible voluntary contributions to the plan during his years of service.

In determining active participation for purposes of the allocation to capital gain, Paolo has 96 months (12 × 8 – 1966 counts as 12 months) of participation before 1974 and 243 months (240 + 3 — March 1995 counts as a full month) of participation after 1973.

Paolo's taxable distribution is \$175,000 calculated as follows:

Total Distribution	\$205,000
Less: Employee Contributions	\$ 10,000
Less: NUA	\$ 20,000
Total Taxable Amount	\$175,000

Of this total taxable amount, the portion allocated to capital gain is computed as follows:

$$\frac{\$175,000 \times 96 \text{ (pre-1974 months)}}{339 \text{ (total months)}} = \$49,558$$

The allocation to ordinary income would be as follows:

$$\frac{\$175,000 \times 243 \text{ (post-1973 months)}}{339 \text{ (total months)}} = \$125,442$$

Since Paolo was age 53 on January 1, 1986 (born before 1936), he is eligible to elect 10-year averaging for the ordinary income from the lump-sum distribution. If he elects 10-year averaging, the separate tax on the ordinary income would be:

⁴¹ Rev. Rul. 57-114.

⁴² Prop. Treas. Reg. Section 1.402(e)-2(d)(3)(iii).

The tax on \$12,544.20 (1/10 of \$125,442) = \$1,927.14
 $\$1,927.14 \times 10 = \$19,271.40$
 Separate tax on ordinary income = \$19,271.40
 Tax on capital gain portion (20% \times \$49,558) = \$9,911.60
 The total tax is \$29,183.00 (\$19,271.40 + \$9,911.60)

Preretirement Distributions

In general, for distributions made after July 1, 1986, the basis recovery rules depend on the timing of the distributions. There are different rules depending on whether the participant begins distributions before the *annuity starting date* or after such date.

Distributions received before the annuity starting date (pre-retirement distributions) made to an employee who has a cost basis under a pension, profit-sharing, or stock bonus plan, or under an annuity contract purchased by any such plan, are taxed as ordinary income under a rule that provides for pro-rata recovery of cost.⁴³ The employee excludes the portion of the distribution that bears the same ratio to the total distribution as his investment in the contract bears to the total value of the employee's accrued benefit on the date of the distribution. Generally, the total value of an employee's account balance is the FMV of the total assets under the account, excluding any net unrealized appreciation attributable to employee contributions (whether or not all such securities are distributed). The premature distribution penalty tax may apply if an amount is received before age 59½, unless another exception applies.

The *annuity starting date* is the first day of the first period for which an amount is received as an annuity under the plan or contract.⁴⁴

Grandfather Rule

If a plan permitted in-service withdrawal of employee contributions on May 5, 1986, the pro-rata recovery rules do not apply to investment in the contract prior to 1987. Instead, the pre-1987 investment in the contract will be recovered first, and the pro-rata recovery rules will apply only to the extent that amounts received before the annuity starting date (when added to all other amounts previously received under the contract after 1986) exceed the employee's investment in the contract as of December 31, 1986.⁴⁵

If employee contributions are transferred after May 5, 1986, from a plan that permitted in-service withdrawals to another plan permitting such withdrawals, the pre-1987 investment in the contract under both plans continues to qualify for grandfather treatment. If the transferor plan did not permit such in-service withdrawals, only the pre-1987 investment in the contract under the transferee plan qualifies.⁴⁶

Even if an employee cashed out prior to 1986 and buys back after 1986, he or she cannot use the grandfather rule, because there is no pre-1987 investment in the contract. But, if the cash-out occurs after 1986, and there was investment in the contract as of December 31, 1986, the cashout causes a permanent reduction in the grandfathered investment, which may not be restored by a later buyback.⁴⁷

⁴³ IRC Sections 402(a); 72(e)(8).

⁴⁴ IRC Section 72(c)(4).

⁴⁵ IRC Section 72(e)(8)(D); Ltr. Rul. 9652031.

⁴⁶ Notice 87-13 (1987-1 CB 432); Ltr. Rul. 8829017, 8829006.

⁴⁷ Notice 89-25, A-5 (1997-1 CB 662).

Distribution of Annuity or Life Insurance Contract

If an annuity contract is distributed, the employee will not be taxed on its value unless and until he or she surrenders the contract. The employee will be taxed on the annuity payments as they are received. A contract issued after 1962, however, must be nontransferable in order to qualify for this tax-deferred treatment.⁴⁸ However, the transfer of an annuity to a divorced spouse pursuant to a divorce decree will not violate the nontransferability requirement.⁴⁹ A IRC Section 1035 exchange to a similar contract meeting the nontransferability restrictions and other applicable requirements does not necessarily violate the nontransferability.⁵⁰

If the employee surrenders the annuity contract after the year of distribution, the gain realized on surrender is taxable as ordinary income and will not qualify for taxation as a lump-sum distribution.⁵¹ However, the unsurrendered annuity contract will affect the taxation of any lump-sum distribution of which it is a part or which is made in the same year. If the annuity is surrendered in the year of distribution, the proceeds will either be taxed as ordinary income, or, if the distribution of the annuity is part or all of a lump-sum distribution, under the lump-sum distribution rules. If the annuity is distributed in an eligible rollover distribution, tax may be deferred by rolling the amount over to IRA or other plan that accepts rollovers (and in accordance with the rules under such plan). The employee's cost basis is deducted first from the cash and property other than the annuity. Any excess is used to reduce the value of the annuity.⁵²

Life Insurance Contract

If a retirement income or endowment contract, or life insurance policy is distributed, its cash value is immediately taxable to the employee to the extent that it exceeds the employee's basis unless:

- The contract is converted to an annuity (with no life insurance element) no later than 60 days after it is distributed; or
- The contract (or its proceeds if a life insurance contract) is rolled over⁵³

The contract itself may not be rolled over to an IRA.⁵⁴ If the policy is distributed in a lump-sum distribution, the taxable amount is eligible for favorable capital gains and special averaging treatment to the extent that such rules are still applicable.

If death occurs after the policy has been distributed from the plan, the beneficiary is not subject to tax on the policy proceeds.⁵⁵

Disability Benefits

The tax treatment of disability payments from a qualified plan depends upon whether the payments are made to a common-law employee or a self-employed individual:

⁴⁸ IRC Section 401(g); Treas. Reg. Sections 1.402(a)-1(a)(2), 1.401-9.

⁴⁹ Ltr. Rul. 8513065.

⁵⁰ See, Ltr. Rul. 9241007, 9233054; GCM 39882 (10-30-92).

⁵¹ Rev. Rul. 81-107, 1981-1 CB 201.

⁵² Treas. Reg. Sect. 1.402(a)-1(a)(2).

⁵³ Treas. Reg. Sections 1.402(a)-1(a)(2), 1.401-9; Rev. Rul. 60-84, 1960-1 CB 159. However, in a springing cash value policy (where the FMV of the policy is substantially higher than its cash value), then the total reserves are used, not the cash value. See Notice 89-25, 1989-1 CB 662, A-10.

⁵⁴ IRC Section 408(a)(3).

⁵⁵ IRC Section 101(a); Rev. Rul. 63-76, 1963-1 CB 23.

- *Payments to a common law employee.* If the disability pension is derived from employer contributions and is made in lieu of wages to an employee who retired on account of permanent and total disability, the employee may be entitled to a tax credit.⁵⁶ A common-law employee is not entitled to exclude from income any part of a disability benefit derived from employer contributions.⁵⁷
- *Payments to self-employed individuals.* If a self-employed individual receives distributions from a plan because he or she became permanently disabled, the disability payments are taxed under the same rules that apply to retirement benefits. But if the self-employed individual receives the disability payments through health insurance, he may exclude from his gross income any amounts attributable to nondeductible contributions as a self-employed person.⁵⁸

Death Benefits

Death benefits payable under a qualified retirement plan are generally included in the deceased participant's gross estate.⁵⁹ The income tax treatment to the beneficiary depends on how the death benefit payments are paid. For example, 10-year forward income averaging treatment may be available for a lump-sum distribution. Distributions from annuity contracts are generally subject to pro-rata recovery rules.

Note. The repeal of the \$100,000 estate tax exclusion under the Tax Reform Act of 1984,⁶⁰ does not apply (remains available) if the participant terminated employment before 1985.

Note. If the participant terminated employment before 1983 there may be a total exclusion of the death benefits if the individual was not in pay status prior to 1985, and irrevocably elected prior to July 18, 1984, the beneficiary and the form of benefit to be paid in the future. The exclusions apply to qualified plans, but not to IRA-based plans.⁶¹

Note. If the death benefits are subject to both estate tax and income tax, the beneficiary will be entitled to an income tax deduction for the estate tax attributable to the death benefits.⁶²

Where the participant's estate is the beneficiary, the estate is not allowed an estate tax deduction for the income tax paid by the estate with respect to the death benefit distribution⁶³ nor a discount to reflect the potential income tax liability that will be incurred by the beneficiary upon receipt.⁶⁴

Charitable Beneficiary

If the death benefit is payable to a charitable organization, an estate tax charitable deduction is allowable. If the death benefits are payable to a charitable remainder trust, a partial estate tax charitable deduction is

⁵⁶ IRC Section 22(a).

⁵⁷ Social Security Amendments Act of 1993, Section 122(b).

⁵⁸ IRC Sections 104(a)(3), 105(g); Treas. Reg. Section 1.105-1(a), (b); See, too, Treas. Reg. Section 1.72-15(g).

⁵⁹ IRC Section 2039; but where decedent designated his estate as beneficiary of his plan benefits, the decedent's will named a charity as the residual beneficiary of his estate, and the estate assigned the plan's death benefit to a charity, the estate was not required to include the plan's death benefits in its gross income; see, also, PLRs 200526010, 200520004.

⁶⁰ IRC Section 2039; Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Section 245(c), as amended by the Deficit Reduction Act of 1984 (DRA 84) (the H.R. 4170).

⁶¹ IRC Section 2039; Temp. Treas. Reg. Section 20.2039-T, Q&A-2; TEFRA Section 245(c), as amended by TRA 86. Section 525; Rev. Rul. 92-22, 1992-CB 313.

⁶² IRC Section 691(c); PLR 200316008; IRS Field Service Advice 200011023.

⁶³ PLR 200444021.

⁶⁴ Estate of Smith v. United States, No. 04-20194 (5th Cir. 2004).

allowable.⁶⁵ However, death benefits paid upon an individual's death to a charitable organization or to a charitable remainder trust are not subject to income tax because the charitable beneficiary is exempt from tax.⁶⁶

Recovery of Life Insurance Protection Costs

If an employee dies before retirement and the death benefit is payable from the proceeds of a life insurance policy, the difference between the cash surrender value and the face amount is treated as the death proceeds of life insurance, and is excluded from income,⁶⁷ but only if the insurance cost (under Table 2001 or the P.S. 58 rates⁶⁸) has been paid with nondeductible employee contributions or has been taxable to the employee.⁶⁹ The balance of the proceeds (representing the cash surrender value) is treated as a distribution from the plan.⁷⁰

The amount of the proceeds that is equal to the cash surrender value of the policy is generally included in the beneficiary's gross income (the death benefit). Any proceeds in excess of the cash surrender value of an insurance policy are not subject to federal income tax.⁷¹

The beneficiary's taxable amount is, however, reduced by the current life insurance protection costs that were included in the deceased participant's gross income during such participant's lifetime.⁷² The current life insurance protection costs that are included in gross income are treated as a tax-free return of the participant's investment in the contract.⁷³

However, these costs can be recovered only if the original insurance policy is distributed to the employee. If the life insurance is surrendered and the cash value and investment fund are used to purchase an annuity, the current life insurance protection costs are not part of the participant's cost for the annuity because the benefits will not be provided under the same contract. In addition, if the policy is surrendered by the plan's trustee and the cash surrender value is distributed to the participant, the participant's current life insurance protection costs are not recoverable. However, if the participant elects an annuity settlement option under the original policy, the current life insurance protection costs are recoverable.⁷⁴

Policy Valuation

Generally, the stated cash surrender value of the policy is used as its fair market value for purposes of determining the amount includible in income. However, this method is not appropriate where the total policy reserves, including life insurance reserves (if any), together with any reserves for advance premiums, dividend accumulations, and so on, represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value.⁷⁵

⁶⁵ IRC Section 2055; PLRs. 9818009, 200230018.

⁶⁶ IRC Sections 501(a), 664(c).

⁶⁷ IRC Section 101(a).

⁶⁸ The table of one-year premium rates set forth in Rev. Rul. 55-747, 1955-2 CB 228, is more commonly referred to as the "P.S. 58" rates. Notice 2001-10 set forth a new table of one-year term premiums, Table 2001, to determine the value of current life insurance protection on a single life provided under a split-dollar life insurance arrangement for taxable years ending after January 29, 2001. Under Notice 2001-10, Table 2001 is to serve as a substitute for the outdated P.S. 58 rates.

⁶⁹ Treas. Reg. Section 1.72-16(c)(4).

⁷⁰ IRC Section 72(m)(3)(C); Treas. Reg. Section 1.72-16(c).

⁷¹ IRC Section 101(a).

⁷² See IRS Notice 2002-8 (2002-1 CB 398); Rev. Ruls. 66-110 (1966-1 CB 12), 67-154 (1967-1 CB 11).

⁷³ Treas. Reg. Section 1.72-16(b).

⁷⁴ IRC Section 72; Treas. Reg. Section 1.72-16(b); Rev. Rul. 67-336 (1967-2 CB 66).

⁷⁵ See Rev. Proc. 2005-25 (2005-17 IRB 962); see also, IRS Notice 89-25.

Failure to Withdraw a Required Minimum Distribution

If the amount distributed during a tax year is less than the amount required to be distributed under the RMD rules for the year, there is generally a tax equal to 50 percent of the amount that the distribution made in the year falls short of the required amount. The tax is on the payee.⁷⁶

Premature Distribution Penalty Tax

Amounts distributed prior to age 59½ from a qualified plan, SEP, SIMPLE IRA, or 403(b) arrangement may be subject to a nondeductible excise tax of 10 percent. The penalty may also apply to assets that were subject to the restriction and which were transferred into and later distributed from an eligible governmental 457 plan. If the penalty tax on early distributions from a SIMPLE IRA applies to a distribution within the two-year period, the tax increases from 10 percent to 25 percent.⁷⁷

There are a number of exceptions to the early distribution penalty tax if the individual is under age 59½. As noted, some of the exceptions only apply to qualified plans, some only to IRAs, and some to employees that have separated from service. If under age 59½, one of the other exceptions may apply, and the exceptions are as follows.

Death

The early distribution is made to a beneficiary (or to the estate of the employee or IRA owner) upon or after the death of the employee or IRA owner.

Disability

The distribution is attributable to the employee's or IRA owner's being disabled within the meaning of IRC Section 72(m)(7).

An individual is considered to be disabled if he or she is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." Proof of the existence of such disability must be provided. (See IRC Section 72(m)(7); Treas. Reg. Section 1.72-17A(f).)

In a recent Tax Court case involving the definition of disability under IRC Section 72(m), the court found that a particular taxpayer's continuing depression qualified for the standard for the disability exception and was not liable for the 10 percent early distribution penalty.⁷⁸

Substantially Equal Periodic Payments

The early distribution is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or IRA owner or the joint lives (or joint life

⁷⁶ IRC Section 4974.

⁷⁷ IRC Section 72(t)(6).

⁷⁸ See, *Coleman-Stephens v. Comm'r*, T.C. Summ. Op. 2003-91 (2003). The case was heard pursuant to the provisions of IRC Section 7463 regarding judicial proceeding involving disputes of less than \$50,000. Although such decisions are not reviewable by any other court and the opinion should not be cited as authority, it is nevertheless instructive of the IRS's view of the disability exception and the court's analysis of the IRS's position. For a copy, see <http://www.ustaxcourt.gov/InOpHistoric/Coleman-Stephens.SUM.WPD.pdf>.

expectancies) of the employee or IRA owner and his or her designated beneficiary. Under this exception, distributions from IRC Section 401(a) qualified plans must begin after separation from service.⁷⁹

Qualified Higher Education Expenses

An IRA distribution is used to pay qualified higher education expenses (including graduate education) for the employee, the employee's spouse, or any child or grandchild of either.

First-time Homebuyer Expenses

An IRA distribution for first-time homebuyer expenses is limited to a lifetime maximum of \$10,000. The distribution must be used within 120 days to buy, build, or rebuild the principal residence of the individual, his or her spouse, or any child, grandchild, or ancestor of either. A person qualifies as a first-time homebuyer if he or she (and his or her spouse) has had no ownership interest in a principal residence during the preceding two years.

Unreimbursed Medical Expenses

The distribution does not exceed the amount allowable as a deduction under IRC Section 213 relating to amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).

Medical Insurance for Unemployed Individuals

To the extent of medical insurance paid during the year for an individual, an individual's spouse or dependents, provided all five of the following conditions apply:

1. The distribution is made from an IRA.
2. The individual lost his or her job.
3. The individual received unemployment compensation paid under any federal or state law for at least 12 consecutive weeks.
4. The distribution is received either during the year the unemployment compensation was received or the following year.
5. The distribution is received no later than 60 days after the individual has been reemployed.

IRS Levy

The early distribution is made on account of a levy under IRC Section 6331.

Note. The IRS can enforce a federal lien against an IRA.⁸⁰ Amounts distributed from an IRA, even if used to satisfy a federal lien, are generally (but not always) subject to the premature distribution penalty if the IRA owner is under age 59½. (See Chief Counsel Notice N(36)000-2 (Jan 21, 2000).)

⁷⁹ IRC Section 72(t)(3)(B).

⁸⁰ IRC Section 6334.

Divorce or Separation

Divorce or separation are exceptions to the premature distribution penalty tax in the following circumstances:

- *IRA, Roth IRA, or SIMPLE IRA.* Amounts directly transferred to an IRA, Roth IRA, or the SIMPLE IRA of a spouse (or former spouse) under a divorce or separation instrument under IRC Section 408(d)(6) are not subject to penalty tax because they are not taxable nor are they deemed taxable for this purpose.⁸¹ The amounts are or simply become the IRA or SIMPLE IRA of the spouse (or former spouse). Assets that are rolled over to the spouse's IRA (other than by direct transfer) do not qualify under this exception, and are taxable to the initial recipient.
- *Qualified plans and annuities.* Plans qualified under IRC Sections 401(a) and qualified annuity plans under IRC Section 403(a) are subject to the QDRO rules requiring payments to an alternate payee (generally, the former spouse) that are made pursuant to a state domestic relations law (including community property law).⁸² Payments under a QDRO or domestic relations order (DRO) are not subject to the premature distribution penalty tax.

Separation After Age 55

Distributions from a qualified plan or qualified annuity plan after attainment of age 55 after separation from service is an exception to the distribution penalty tax. The age requirement must be satisfied before the separation from service occurs to qualify under this exception.

ESOP Dividends

Distributions with respect to a qualified ESOP of dividends on employer securities are exceptions from the early distribution penalty tax.⁸³

Qualified Charitable Distributions

A *qualified charitable distribution* is any distribution from an IRA (or Roth IRA) directly by the IRA trustee or custodian to an organization described in Code Section 170(b)(1)(A) (other than an organization described in IRC Section 509(a)(3) or a donor advised fund (as defined in IRC Section 4966(d)(2))). Tax-free distributions from individual retirement plans for charitable purposes (qualified charitable distributions or QCD) are also exceptions to the early distribution penalty tax.⁸⁴

Note. The amount transferred will be treated as coming from the taxable portion of an IRA and will be another exception to the pro-rate recovery rules applicable to traditional IRAs.

In the case of qualified charitable distributions, the Pension Protection Act of 2006 (PPA) provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional IRA or Roth IRA. The provision does not apply to distributions from employer-sponsored retirement plans, including an “ongoing” SIMPLE IRA or SEP IRA. If the distribution is excluded from gross income, the 10 percent penalty tax does not apply.

⁸¹ IRC Sections 72(t)(1), 408(d)(6).

⁸² IRC Section 414(p)(1).

⁸³ IRC Sections 72(t)(2)(A)(vi), 404(k).

⁸⁴ IRC Section 408(d)(8), as added by PPA '06, Section 1201(a); See IRS Notice 2007-7, Part IX, 2007-5 IRB 395 (January 29, 2007).

Note. The exclusion for qualified charitable contributions applies to an IRA containing SEP or SIMPLE assets provided the plan is not “ongoing.” A SEP or SIMPLE-IRA is *ongoing* if it is maintained under an employer arrangement under which contributions are made for the plan year ending with or within the IRA owner's taxable year in which the charitable contribution would be made. Transferring any or all of amount from such an account into a traditional IRA that does not contain SEP or SIMPLE IRA assets could certainly be transferred from that IRA to charity on a tax free basis.

The exclusion for charitable distributions may not exceed \$100,000 per taxpayer, per taxable year. Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½, and if made by December 31, 2007 (see effective date below). Special rules apply (see below) in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions.

An IRA does not fail to qualify merely because qualified charitable distributions have been made from the account. It is intended that the Treasury Department will prescribe rules under which IRA owners are deemed to elect out of withholding if they designate that a distribution is intended to be a qualified charitable distribution.

Caution: *The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the distribution.*

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the provision) under Code Section 72, and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule. The basis recovery rules continue to apply to a Roth IRA.

Note. Distributions that are excluded from gross income by reason of the qualified charitable distribution provisions are not taken into account in determining the deduction for charitable contributions under Code Section 170.

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (for example, the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example. Alicia has a traditional IRA with a balance of \$100,000, consisting solely of deductible contributions and earnings. Alicia has no other IRA. The entire IRA balance is distributed in a distribution to an organization described in Code Section 170(b)(1)(A) (other than an organization described in IRC Section 509(a)(3) or a donor advised fund). Under present law, the entire distribution of \$100,000 would be includible in Alicia's income. Accordingly, under the provision, the entire distribution of \$100,000 is a qualified

charitable distribution. As a result, no amount is included in Alicia's income as a result of the distribution and the distribution is not taken into account in determining the amount of Alicia's charitable deduction for the year.

Example. Stanley has a traditional IRA with a balance of \$100,000, consisting of \$20,000 of nondeductible contributions and \$80,000 of deductible contributions and earnings. Stanley has no other IRA. In a qualified charitable distribution, \$80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be \$16,000, determined by multiplying the amount of the distribution (\$80,000) by the ratio of the nondeductible contributions to the account balance (\$20,000/\$100,000). Accordingly, under present law, \$64,000 of the distribution (\$80,000 minus \$16,000) would be includible in Stanley's income.

Under the PPA, notwithstanding the present law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is \$80,000. Accordingly, under the provision, the entire \$80,000 distributed to the charitable organization is treated as includible in income (before application of the provision) and is a qualified charitable distribution. Because of this, no amount is included in Stanley's income as a result of the distribution and the distribution is not taken into account in determining the amount of Stanley's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, \$20,000 of the amount remaining in the IRA is treated as Stanley's nondeductible contributions (that is, not subject to tax upon distribution).

A qualified charitable distribution can be made to honor a previous outstanding pledge. Such a distribution would not constitute a prohibited transaction.⁸⁵

The provision relating to qualified charitable distributions is effective for distributions made in taxable years beginning on or after January 1, 2006, and taxable years beginning before January 1, 2008. Thus, the provision is only effective for two years.⁸⁶

Note. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs, and after the death of the owner, Roth IRAs, to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision for qualified charitable contributions. Keep in mind that the individual must be exactly 70½ or older for the penalty exception to apply.

Caution: *Qualified charitable distributions (QCD), which are paid directly to the qualified charity, are reported in the name of the IRA owner as any other actual distributions. The trustee or custodian is not responsible for knowing whether the distribution is or is not tax-free. Federal tax return instructions will instruct taxpayers on how to report a QCD.*

⁸⁵ See IRC Section 4975(d)(9), regarding exemption from prohibited transaction rules for benefits computed and paid to participants ("disqualified persons") on a consistent basis under the plan; IRC Section 408(d)(8)(B)(i); Notice 2007-7, 2007-5 IRB 395 (January 29, 2007).

⁸⁶ Pension Protection Act of 2006 (PPA '06) Section 1201(c); IRC Sections 408(d)(8), as amended by PPA '06, Section 1201(a).

Qualified Reservist Distribution

A *qualified reservist distribution* is a distribution (1) from an IRA or attributable to elective deferrals under a 401(k) plan, 403(b) annuity; (2) made to an individual who (by reason of being a member of a reserve component)⁸⁷ was ordered or called to active duty for a period in excess of 179 days or for an indefinite period; and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. A 401(k) plan or 403(b) annuity does not violate the distribution restrictions applicable to such plans by reason of making a qualified reservist distribution.

Individuals called to active duty for at least 180 days (or an indefinite period).⁸⁸ Under the PPA, the 10 percent early withdrawal tax does not apply to a qualified reservist distribution from a traditional IRA. The two-year period for making recontributions of qualified reservist distributions does not end before August 17, 2008, the date that is two years after the date of the PPA was enacted.

Note. The qualified reservist distribution exception does not apply to a SARSEP or SIMPLE IRA plan.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to the provision. No deduction is allowed for any contribution made under the provision.

This provision applies to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007. The two-year period for making recontributions of qualified reservist distributions does not end before August 17, 2008, the date that is two years after the date of the PPA was enacted. If refund or credit of any overpayment of tax resulting from the provision would be prevented at any time before the close of the one-year period beginning on the date of the enactment by the operation of any law or rule of law (including *res judicata*), such refund or credit may nevertheless be made or allowed if claim therefore is filed before the close of such period.⁸⁹

Example. Sally, a qualified reservist, was called to active duty on August 1, 2006. For personal reasons, Sally takes an IRA distribution on September 14, 2006. The 10 percent penalty tax for early withdrawal will not apply. Assuming that Sally is relieved of active duty on May 20, 2008, she will have until May 20, 2010 (the later of two years after the date of enactment or two years after the end of his active duty) to roll over the 2006 distribution amount and avoid having to pay federal income tax.

Distributions to a Qualified Public Safety Employee

Distributions to a qualified public safety employee from a government defined benefit plan are exceptions to the early distribution penalty tax. The term qualified public safety employee means an employee of a State or a political subdivision of a State (such as a county or city) whose principal duties include services requiring specialized training in the area of police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the State or the political subdivision of the State.⁹⁰

⁸⁷ As defined in section 101 of title 37 of the U. S. Code.

⁸⁸ IRC Section 72(t)(G)(3)(iii)(I); See, too, most current version of IRS Publication 4492—*Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma*.

⁸⁹ PPA '06, Section 827(c); IRC Section 72(t)(G)(2), as amended by PPA '06, Section 827(a).

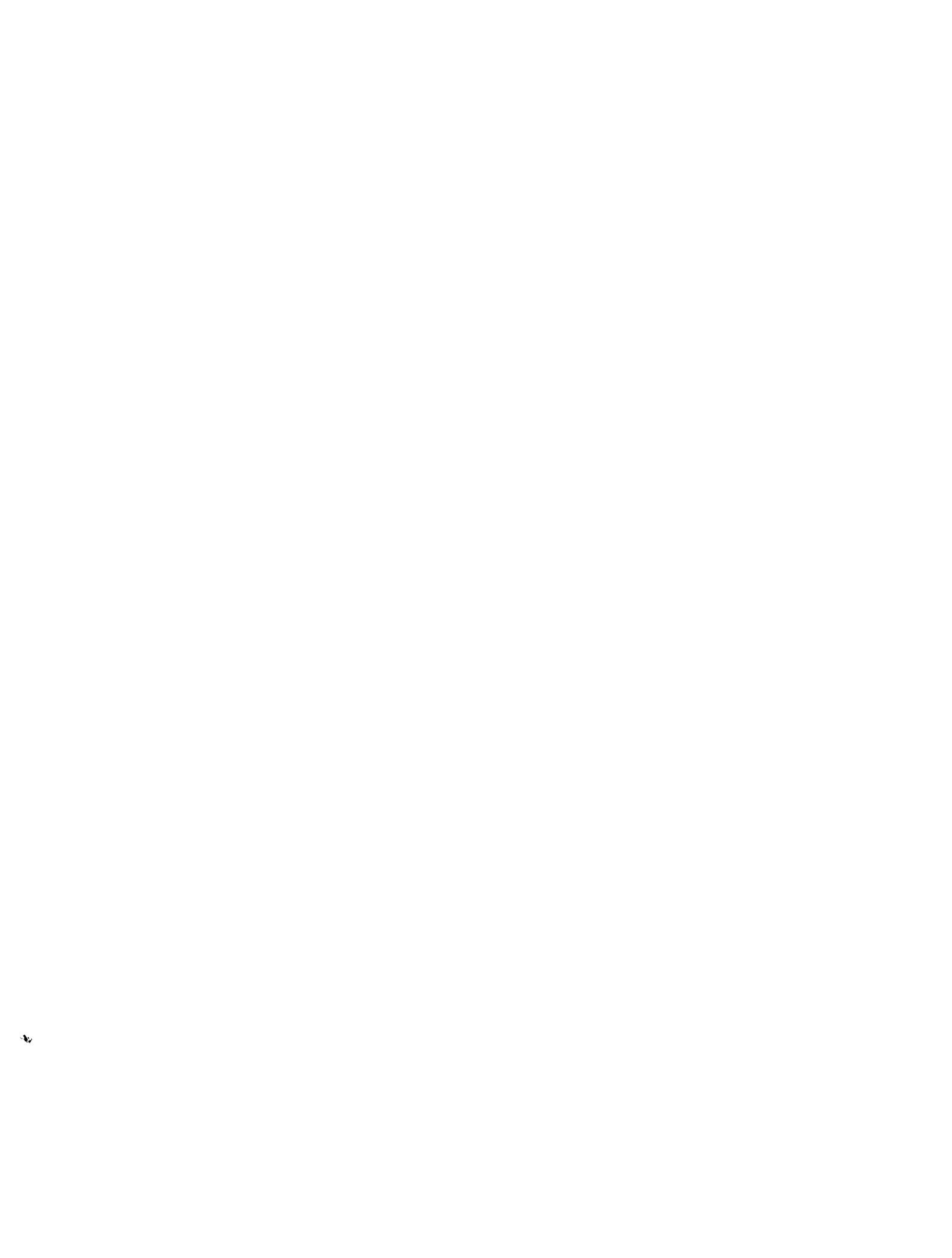
⁹⁰ IRC Section 72(t)(10), added by PPA '06, Section 828; IRS Notice 2007-7, Part IV, 2007-5 IRB 395 (January 29, 2007)

Hurricane Distributions Exception

The 10 percent penalty was waived for hurricane Katrina victims in specified areas as long as the “qualified Hurricane Katrina” distributions from the individual’s IRA (or qualified plan) do not exceed \$100,000 in the aggregate. Income tax on such distributions can be made (ratably) over a three-year period unless the taxpayer elects to have the entire distribution treated as taxable in the year of distribution. However, amounts recontributed during the three-year period are treated as rollovers and the tax can be recovered by filing an amended federal income tax return. A “qualified Hurricane Katrina distribution” is defined as “any distribution from an eligible retirement plan made on or after August 25, 2005, and before January 1, 2007, to an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss by reason of Hurricane Katrina.” The term “eligible retirement plan” is defined in Code Section 402(c)(8)(B) (which includes a qualified plan, IRA, 403(b), and 457 plans). In addition, distribution made on or after February 28, 2005, and before August 29, 2005, to purchase or construct a principal residence in the hurricane Katrina disaster area that was not so purchased or constructed because of hurricane Katrina can be contributed back to the IRA (or qualified plan) during the period beginning on August 25, 2005, and ending on February 28, 2006.⁹¹ The current deadline of February 28, 2006, was further extended to August 28, 2006 for certain acts.⁹² (See Publication 4492.)

⁹¹ Katrina Emergency Tax Relief Act of 2005, Sections 101, 102 (H.R. 3768).

⁹² IR-2006-30 (Feb. 17, 2006); Notice 2006-20 (Feb 17, 2006); see also Publication 4492—Information For Taxpayers Affected by Hurricanes Rita, Katrina and Wilma; IR-2006-151 (Sept. 27, 2006), reminder: taxpayers in certain areas severely damaged by Hurricane Katrina have until Oct. 16, 2006, to file their income tax returns for 2004 and 2005; IR-2006-135, (August 25, 2006), businesses in the Gulf Coast receive additional postponement to Oct. 16, 2006, of the deadline of time to file and pay; IR-2006-96 (June 19, 2006), certain taxpayers from 31 Louisiana parishes, 49 Mississippi counties and 11 Alabama counties affected by Hurricane Katrina have until Oct. 16, 2006, to file 2004 and 2005 individual income tax returns.



Chapter 16

Rollovers and Portability

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With certain exceptions, distributions from qualified plans, 403(b) arrangements and 457(b) plans are eligible to be rolled over (rollover eligible) to an eligible retirement plan. In this chapter, we will discuss the portability of assets between eligible retirement plans, including individual retirement accounts (IRAs). We will also discuss distribution issues, such as timing, triggering events and tax withholding requirements. Please see our portability chart at the end of the chapter for a summary of the rollover permissibility rules.

General Rollover Rules

Qualified Plans, 403(b) and 457(b) Plans to Eligible Retirement Plans

Except in cases where in-service withdrawals are permitted, distributions from qualified plans¹, 403(b) arrangements and 457(b) plans can occur only if the participant experiences a triggering event. Triggering events are defined under the plan document or agreement. For instance, a plan may require a participant to reach the age of 59½ and/or terminate from employment with the plan sponsor in order to be eligible to make a withdrawal from the plan. Reaching age 59½ and/or terminating from employment would be a triggering event under that plan. Because triggering events vary among plans, a participant must check with the plan administrator, or in the case of a 403(b) plan, the custodian or annuity provider, to determine whether the participant is eligible to withdraw amounts from the plan.

Participants who are eligible to make withdrawals, may rollover withdrawn amounts to an eligible retirement plan², providing the amount is rollover eligible, and the plan is designed to accept such rollovers. For this purpose, eligible retirement plans are the following:

- *Qualified plans* as defined under Internal Revenue Code (IRC or the Code) Section 401(a). A qualified plan can be categorized as either a defined benefit plan or defined contribution plan. Defined contribution plans include money-purchase pension, profit-sharing, 401(k), and stock bonus plans.³

¹ Defined in IRC Section 401(a)

² Defined in IRC Sec. 402(c)(8)(B)

³ IRC Sections 402(c), 403(a)(4).

- *Qualified annuity plans described under 403(a)*
- *Tax-Sheltered Annuity or Custodial Account Under IRC Section 403(b)*. An IRC Section 403(b) plan may be established by an educational institution, certain ministers, and other tax-exempt organizations that are exempt from tax under IRC Section 501(c)(3).
- *Governmental 457(b) Plan maintained by an eligible employer*. Beginning with distributions after December 31, 2001, eligible amounts may be rolled over from a 457(b) plan to an eligible retirement plan.
- *An individual retirement account described under IRC Section 408(a)* (traditional Individual Retirement Account).
- *An individual retirement annuity described under IRC Section 408(b)* (traditional Individual Retirement Annuity).

Note. Under the Pension Protection Act of 2006 (PPA), distributions may be rolled over from qualified plans, 403(b) and 457(b) plans to Roth IRAs as a direct Roth Conversion for distributions that occur after December 31, 2007. Prior to this date, the assets must first be rolled over to a traditional IRA and then converted to a Roth IRA.

Note. Distributions from Traditional, SEP and SIMPLE IRAs can be rolled over to an eligible retirement plan, except for non-taxable amounts and amounts that are non-rollover eligible.

Note. SEP IRAs are treated the same as traditional IRAs for portability purposes.

Note. SIMPLE IRAs are treated the same as traditional IRAs for portability purposes, with two exceptions. (1) Assets cannot be rolled over to SIMPLE IRAs, unless they were distributed from a SIMPLE IRA. (2) SIMPLE IRA assets cannot be rolled over to another retirement plan, unless it has been at least two-years since the first contribution was deposited to the SIMPLE IRA.

Plans Not Eligible for Rollover to Traditional IRAs

Distributions from the following plan types may *not* be rolled over to a traditional IRA:

- An ineligible deferred compensation plan (457(f) plan)
- A governmental plan other than a qualified plan, governmental 457(b), or the federal employee's thrift savings plan (TSP)
- Coverdell Education Savings Account (ESA or Education IRA)
- A Retirement Plan from a Foreign Country ⁴

Triggering Events

In order for participants to make withdrawals from qualified plans, 403(b) and 457 plans, they must first meet the plan's eligibility requirements to do so. These eligibility requirements are referred to as triggering events. The triggering events for qualified plans usually include the following:

⁴ In Ltr. Rul. 9833020, a U.S. citizen and resident worked in Canada. The taxpayer was prohibited from rolling a foreign country's retirement savings plan into either a U.S. traditional IRA or other U.S. retirement plan. It was neither a qualified plan nor an IRA. Treaties are discussed.

- Reaching normal retirement age as defined under the plan. Normal retirement ages usually range from age 59½ to age 65. Some plans may require that the participant terminate from employment, in addition to reaching normal retirement age, in order to be eligible to make withdrawals from the plan.
- The participant's death, in which case distributions would be made by the participant's beneficiary.
- The participant being disabled. Disability should be defined under the plan.
- Termination of employment with the employer that sponsored the plan.
- Termination of the plan.

In-service withdrawals may also be permitted from 403(b) and profit sharing plans—including those with 401(k) features, before the participant experiences a triggering event. Some restrict in-service withdrawals to instances where the participant experiences hardship, as defined under the plan.

Amounts attributed to employee deferrals (salary deferrals) may not be distributed as an in-service withdrawal, unless a triggering event such as separation from service or attainment of normal retirement age occurs.

Conditions for Rolling Over to An Eligible Retirement Plan

Whether assets can be rolled over to an eligible retirement plan depends on the type of plan and the plan provisions.

Rollovers to IRAs

Any balance that is rollover eligible can be rolled over to a Traditional IRA, including a simplified employee pension (SEP) IRA. See definition of rollover eligible distributions later. An IRA custodian will generally require the IRA owner to provide written instructions to make the rollover contribution to the IRA.

Practice Pointer: Because the funding vehicle for a SEP IRA is a traditional IRA, the rules that apply to a traditional IRA also apply to a SEP IRA, unless specifically stated otherwise. SIMPLE IRAs are different. Except for rollover contributions from another SIMPLE IRA, no rollover contributions may be made to a SIMPLE IRA

Rollovers to qualified plans

Although the regulations allow rollover contributions to qualified plans, a plan sponsor is not required to permit rollover contributions to its plan. Therefore, in order for amounts to be rolled over to a qualified plan, the qualified plan must be designed to include language that allows the plan to accept rollover contributions. The plan document should be consulted, not only to determine if rollover contributions are allowed, but also if there are restrictions on the type of rollovers that are allowed. The following are examples of rollover restrictions:

- Rollovers are permitted, except for distribution of assets from traditional IRAs
- Rollovers are permitted from all eligible retirement plans. However in the case on a rollover from an IRA, the IRA must be a 'conduit IRA', which holds only assets that were distributed from a qualified plan or 403(b) account.

Example. Abigail has a conduit IRA consisting of only assets that were rolled over from her previous employer's qualified plan. Abigail's new employer maintains a qualified plan that permits participants to roll over amounts from "plans qualified under IRC Section 401(a), eligible governmental 457(b) plans and 403(b) arrangements." Abigail's conduit IRA is not permitted to be rolled over into new employer's qualified plan because the plan does not permit rollover contributions from IRAs.

Alternatively, if Abigail had requested a direct rollover from her previous employer's plan, to her new employer's qualified plan, the transaction would have been permitted.

Withdrawal of Rollover Contributions Made to Qualified Plans

The options for withdrawing amounts credited to a qualified plan as rollover contributions depend on whether the plan separately accounts for the rollover amounts⁵. If the plan separately accounts for rollover contributions, the assets attributed to the rollover contribution can generally be distributed to the participant at any time, as the triggering event requirements that apply to the rest of the plan's assets would not apply to the rollover contribution amounts.

Example. Company A maintains a profit sharing plan to which it allows rollover contributions from other eligible retirement plans. 35 year old John's account balance of \$100,000 under Company A's plan includes \$ 70,000 that he rolled over from his IRA. Despite the fact that John was under retirement age and not eligible to make withdrawals from his profit sharing, he may withdraw the \$70,000 at anytime, because Company A accounted separately for the rollover contribution amounts.

While rollover amounts that are separately accounted for are not subject to the timing requirements of the receiving plan, they are subject to the survivor annuity requirement, the required minimum distribution (RMD) requirements, and the 10 percent additional tax that applies to early distributions. Therefore, a 75 year-old participant who rolls over his traditional IRA balance to his qualified plan account after satisfying the RMD for the IRA for the year, does not need to take any additional RMDs from that amount until he retires from that employer.

Maximum Amount Eligible for a Rollover or Direct Rollover

For eligible rollover distributions prior to January 1, 2002, only the taxable portion of the distribution from a qualified plan or 403(b) was rollover eligible. However, beginning with distributions after December 31, 2001, eligible rollover distributions include the employee's after-tax balance.⁶

Rollover eligible amounts can be credited to the receiving account as an indirect rollover (60-day rollover) or a direct rollover. With an indirect rollover, the assets are made payable to the participant, and must be deposited to the receiving plan within 60-days of the participant receiving the assets. With a direct rollover, the assets are made payable to the receiving retirement plan. (*Note that indirect rollovers may be subject to income tax withholding which would then be credited as taxes paid on the taxpayer's tax return.*)

Rollovers of After-Tax Employee Contributions

While pre-tax amounts can be rolled over to a qualified plan, 403(b) or 457(b) plans as an indirect or a direct rollover, after-tax amounts can only be processed as a direct rollover to these plans. If after-tax contributions are transferred to a qualified plan or to a 403(b) plan, the receiving plan must keep separate accounting records of after-tax amounts and any applicable earnings on those contributions.

⁵ Rev Rul 2004-12

⁶ IRC Section 402(c)(2).

After-tax contributions can be rolled over to a traditional IRA, either as a 60-day indirect rollover or as a direct rollover. The taxpayer is required to keep track of the after-tax amounts by filing IRS Form 8606. Form 8606 not only keeps track of the after-tax balance for the taxpayer, but also helps to let the IRS know that distributions of those amounts are tax-free and not subject to the 10 percent additional tax on early distributions. The financial institution accepting the rollover contribution to the traditional IRA is not responsible for maintaining separate accounting of the after-tax balance of the IRA.⁷

Qualified Plans

As noted earlier, after-tax contributions made to a qualified plan may only be rolled over to another qualified plan that accepts these rollovers, and must be done as a direct rollover. No indirect rollover is permitted of after-tax contributions, except to a traditional IRA.

After-tax amounts in a qualified plan cannot be rolled over to a 403(b) or 457(b) plan, but are eligible to be rolled over to a traditional IRA, either as a rollover or indirect rollover.

403(b) Plans

After-tax amounts in a 403(b) plan may be rolled over to another 403(b) or a qualified plan as a direct rollover. Indirect rollovers of after-tax amounts between 403(b) accounts are not permitted. After-tax amounts in a 403(b) are not eligible to be rolled over to a 457(b) plan, but are eligible to be rolled over to a traditional IRA, either as a rollover or indirect rollover.

Eligible Rollover Distributions

Assuming the plan permits the distribution, an eligible rollover distribution⁸ is *any* distribution except the following:

1. A distribution that is part of a series of substantially equal payments made
 - a. over a period of 10 years or longer, or
 - b. over the participant's life or life expectancy, or over the joint lives or joint life expectancies of the participant and the participant's designated beneficiary
2. Required minimum distribution (RMD) amounts
3. Any distribution which is made upon hardship of the employee, or in the case of a 457(b) plan, any distribution on account of an unforeseeable emergency
4. Distributions to spouse beneficiaries that qualify for the death benefit exclusion under IRC Sec. 101(b).
5. Death distribution made to nonspouse beneficiaries, unless the plan allows such rollovers. (*Under the Pension Protection act of 2006, non-spouse beneficiaries may rollover inherited amounts from qualified plans, 403(b) or 457(b) plans to inherited IRAs, if the plan allows.*)
6. Distributions due to a qualified domestic relations order (QDRO) paid to a nonspouse alternate payee

Additional exceptions found in the IRS regulations include:

7. Return of an excess contribution, excess deferral, or excess annual addition, together with the income allocable to these corrective distributions⁹

⁷ IRC Section 402(f) Notice, Section 1.

⁸ IRC Section 402(c)(4); Treas. Reg. Section 1.402(c)-2, Q&A 3.

⁹ Treas. Reg. Section 1.415-6(b)(6)(iv).

8. The cost of life insurance coverage
9. Deemed distributions upon the default of a participant loan,
10. Dividends paid on employer securities in an employee stock ownership plan (ESOP)¹⁰

Practice Pointer: An eligible rollover distribution includes employer securities and loan-offset amounts, discussed later. Distributions that are not rollover eligible rollover are exempt from the 20 percent mandatory income tax withholding requirements, but are subject to the voluntary withholding rules. When a rollover contribution may include employer securities, care must be taken to determine whether it is more beneficial to deposit those amounts in a non-retirement account in light of the net unrealized appreciation and reduced tax treatment that may apply to these amounts.

Distribution Timing of Amounts Rolled Over to Employer Plan

As noted earlier, if an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan, distributions of those amounts are not subject to the timing restrictions that apply to distributions of other amounts from the plan.¹¹ Thus, a plan may permit the distribution of amounts attributable to rollover contributions at any time pursuant to an individual's request. However, other requirements applicable to the receiving plan may apply.

Example. A money-purchase pension plan separately accounts for amounts attributable to rollover contributions. A plan provision permitting the in-service distribution of those amounts will not cause the plan to fail the requirements that distributions be made on or after retirement.

Similarly, if the receiving plan is an eligible governmental 457(b) plan or a 403(b) tax-sheltered annuity or custodial account, amounts attributable to rollovers that are maintained in separate accounts are permitted to be distributed at any time even though distribution of other amounts under the plan or contract cannot be made until the occurrence of certain events as defined under the plan.¹²

Survivor Annuity Requirements

A distribution of an amount attributable to a rollover contribution is subject to any survivor annuity requirements as applicable to the receiving plan.¹³

Minimum Distribution Requirements

A distribution of an amount attributable to a rollover contribution is subject to the required minimum distribution requirements as applicable to the receiving plan.¹⁴

Exceptions From Premature Distribution Penalty

A distribution of an amount attributable to a rollover contribution is subject to the premature (early) distributions provisions applicable to the receiving plan.¹⁵

¹⁰ As described in IRC Section 404(k).

¹¹ Rev. Rul. 2004-12 (2004-10 IRB 556); IRC Sections 401(a)(31), 402(c), 402(e)(2), 403(a)(5), 403(b)(10), 457(d)(1)(C).

¹² IRC Sections 403(b)(7), 403(b)(11), 457(d)(1)(A).

¹³ IRC Sections 401(a)(11), 417.

¹⁴ IRC Section 401(a)(9).

¹⁵ IRC Section 72(t).

Example. Lisa, age 56, properly rolls over a distribution from her traditional IRA into her employer's money-purchase pension plan that separately accounts for amounts attributable to rollover contributions. The following year, she separates from service. Her distribution is not subject to the 10 percent premature distribution penalty tax because it was distributed from a qualified plan after she attained age 55. Had it been distributed from her traditional IRA, the age 55 exception would not have applied. Although some of the IRC Section 72(t) exceptions only apply to IRAs, others only apply to qualified plans and vice versa. (See Chapter 26, "Nonqualified Deferred Compensation.") In the case of an eligible governmental 457(b) plan, which is not generally subject to the premature distribution penalties, amounts rolled over to a 457 (b) plan are subject to the premature distribution penalties.¹⁶

Merger, Consolidation, and Transfers

Restrictions on the timing of permitted distributions continue to apply in nonrollover situations, such as amounts received by a plan as a result of a merger, consolidation or transfer of plan assets under IRC Section 414(l), or to plan-to-plan transfers, including those permitted between 403(b) tax-sheltered annuities or custodial accounts, and between eligible governmental 457(b) plans.¹⁷

Substantially Equal Payments Not Eligible for Rollover

Change in Amount of Payments or the Distributee¹⁸

If the amount of the payments changes so that subsequent payments are not substantially equal to prior payments, a new determination must be made as to whether the remaining payments are a series of substantially equal periodic payments. This determination is made without taking into account payments made prior to the change. However, a new determination is not made merely because the spouse becomes the distributee upon the death of the employee.

Series of Payments Beginning Before 1993

If a series of periodic payments began before 1993, the determination of whether the post-1992 payments are eligible rollover distributions is made by taking into account all payments made, including payments made before 1993.¹⁹

Example. Holly began payments over 15 years from her qualified plan account in 1983. Although payments made after December 31, 1992, will continue for only five more years, her pre-1993 payments are included in determining the specified period. In this case, her entire series is 15 years, which makes her post-1992 payments ineligible for rollover distribution treatment.

Random or Independent Payments

A payment is treated as independent of other payments in a series if the payment is substantially larger or smaller than the other payments in the series. As a result, such independent payment is an eligible rollover

¹⁶ IRC Section 72(t)(9).

¹⁷ See Rev. Ruls. 2004-12 (2004-10 C.B. 556), 69-277 (1969-1 C.B. 116), 90-24 (1990-1 C.B. 97), 94-76 (1994-2 C.B. 46).

¹⁸ Treas. Reg. Section 1.402(c)-2, Q&A 5(c).

¹⁹ Treas. Reg. Section 1.402(c)-2, Q&A 5(e).

distribution if it is not otherwise excepted from the definition of an eligible rollover distribution. This is the case regardless of whether the independent payment is made before, with, or after payments in the series.²⁰

Example. Heather begins life expectancy payments in 1990 over a 20-year period. In 1993, she decides to close her account and take the entire remaining balance. The 1993 distribution would be considered an eligible rollover distribution since it would be an independent payment larger than the other payments in the series.

Example. Morgan elects a single payment of half of her account balance with the remainder of the account balance paid over Morgan's life expectancy. The single payment is treated as independent of the other payments in the series, and is an eligible rollover distribution.

Substantially Equal Payments From a Defined Contribution Plan

In determining whether a series of payments from a defined contribution plan constitutes substantially equal periodic payments, the following rules apply:²¹

- *Declining years.* A series of payments from an account balance under a defined contribution plan will be considered substantially equal payments over a period if, for each year, the amount of the distribution is calculated by dividing the account balance by the number of years remaining in the period. For example, a series of payments to be made over 10 years is determined as follows: In the first year, the annual payment is the account balance divided by 10; in the second year, the annual payment is the remaining account balance divided by 9; and so on until year the tenth year, when the entire remaining balance is distributed.
- *Reasonable actuarial assumptions for fixed payment amounts.* In situations in which a participant receives a fixed payment on a monthly, quarterly, or annual period, reasonable actuarial assumptions must be used to determine the period of years over which the payments will be made. For example, a participant with \$100,000 in plan assets requests a \$1,000 distribution per month until the account is exhausted. The plan administrator assumes a reasonable rate of interest to be 8 percent per year. Therefore, the account balance will be exhausted in approximately 14 years. Since this period of distribution exceeds 10 years, the \$1,000 per month would not be eligible for roll-over purposes and, therefore, would not be subject to the 20 percent mandatory withholding.

10 Percent Additional Tax

If a participant does not rollover a distribution amount to an eligible retirement plan, the distribution will be subject to the 10 percent additional income tax if the recipient is under the age of 59½ when the distribution occurs, unless an exception applies.

Distributions From a 457(b) Plan

Distributions from a 457(b) plan are not generally subject to the 10 percent additional tax on premature distributions. However, any distribution from a 457(b) that is attributable to any amount rolled over to the 457(b) (adjusted for investment returns) from another type of plan or IRA is subject to the 10 percent additional tax, unless such distribution meets an exception to the 10 percent penalty.

²⁰ Treas. Reg. Section 1.402(c)-2, Q&A 6.

²¹ Treas. Reg. Section 1.402(c)-2 Q&A 5(d).

Distributions From Qualified Plans, 403(b)s and IRAs

Unless an exception applies, distributions from qualified plans, 403(b)s and IRAs are subject to the 10 percent additional income tax. For SIMPLE IRAs, the penalty is increased to 25 percent, if the distribution occurs before it has been two years since the first contribution was made to the SIMPLE IRA. Also, any amount rolled over from a 457(b) plan to another type of eligible retirement plan will be subject to the additional 10 percent tax if it is distributed from the other plan unless an exception applies. In other words, if a 457(b) plan is rolled over to another type of plan, it takes on the characteristics of the receiving plan when subsequent distributions are made. Exceptions to the 10 percent additional tax include the following:

- To the extent the participant has unreimbursed medical expenses that are more than 7.5 percent of his/her adjusted gross income.
- The distributions are not more than the cost of the participant's medical insurance (IRAs only).
- The distributions occurred while the participant is disabled.
- The distribution represents non-taxable amounts.
- The distribution is made to the beneficiary of a deceased participant.
- The participant is receiving distributions under a substantially equal periodic payment over the life (or life expectancy) of the participant or the joint lives of the participant and designated beneficiary.
- The distributions are not more than the participant's qualified higher education expenses (IRAs only).
- The participant uses the distributions to buy, build, or rebuild a first home (IRAs only).
- The distribution is due to an IRS levy.
- The distribution is made after the participant separates from service in or after the year he/she reaches age 55 (age 50 for qualified public safety employees) (Does not apply to IRAs).
- The distribution is made payable to an alternate payee under a qualified domestic relations order (Does not apply to IRAs).
- The distribution is made from an employer plan under a written election that provides a specific schedule for distribution of the participant's entire interest if, as of March 1, 1986, the participant had separated from service and had begun receiving payments under the election. (Does not apply to IRAs.)
- The distribution is made from an employee stock ownership plan for dividends on employer securities held by the plan. (Does not apply to IRAs.)
- From elective deferral accounts under 401(k) or 403(b) plans, or similar arrangements, that are qualified reservist distributions. (Does not apply to IRAs.)

Direct Rollover Election Requirement

A plan participant must be given the option to have his or her eligible rollover distribution made in a direct rollover payment to the trustee or custodian of an eligible retirement plan. For purposes of this rule, an eligible retirement plan includes a traditional IRA account, IRAnnuity, or another employer's plan, which accepts such rollover contributions.²² If an employer fails to permit such an election to his or her employees, the employer's entire plan runs the risk of being disqualified.²³

A qualified plan is required to offer a direct rollover to any defined contribution plan that accepts rollovers, and is permitted (but not required) to offer a direct rollover to a defined-benefit plan that accepts roll-

²² IRC Sections 401(a)(31)(D), 402(c)(8)(B); Treas Reg. Section 1.401(a)(31)-1, Q&A 2.

²³ Treas. Reg. Section 1.401(a)(31)-1, Q&A-1.

overs.²⁴ An eligible rollover distribution that is paid in a direct rollover to an eligible retirement plan, including a defined benefit plan, is not subject to the mandatory 20 percent withholding.²⁵

Irrevocable Rollover Designation

The trustee or custodian of an IRA plan must obtain the written designation of an IRA holder that he or she is irrevocably electing to treat the contribution as a rollover contribution. An election is made by designating to the trustee or issuer of the IRA that the contribution is a rollover contribution. This election is irrevocable. Once any portion of an eligible rollover distribution has been contributed to an IRA and designated as a rollover contribution, taxation of any subsequent distributions from the IRA will be determined under the IRA rules. Thus, any such distributions from the IRA will not be eligible for any favorable tax treatment such as income averaging, even though the original qualified plan distribution may have been eligible for special tax treatment; and the age 55 exception to the 10 percent additional tax on early distributions that applies to qualified plans and 403(b) arrangements. If an eligible rollover distribution is paid to an IRA in a direct rollover at the election of the distributee, the distributee is deemed to have irrevocably designated that the direct rollover is a rollover contribution.²⁶

Withholding Requirements

Mandatory 20 Percent Withholding Requirement

If a participant does not elect to have the eligible rollover distribution from a qualified plan, 403(b) plan, 457(b) plan, or a TSP paid in a direct rollover to another eligible retirement plan, the employer or payor is required to withhold federal income tax at a rate of 20 percent.²⁷ The participant may not waive withholding, but may elect to have more than 20 percent withheld.²⁸

Example. Sherwood Jones is expected to receive a distribution from his qualified plan account in the amount of \$200,000. This entire amount is fully taxable upon distribution and qualifies as an eligible rollover distribution. Sherwood elects to have the distribution paid to him, instead of having it processed as a direct rollover to an eligible retirement plan. Sherwood's employer must withhold and remit 20 percent of the distribution to the Department of the Treasury. The payer must issue a copy of IRS Form 1099-R to Sherwood, which should show the \$200,000 as a taxable distribution and that \$40,000 was withheld for federal income tax. If Sherwood chooses to rollover the distribution within the required 60-day period, he may do either of the following:

Rollover the entire \$200,000: To do so, he will need to make up the \$40,000 out of his regular savings. This would result in the \$200,000 being a nontaxable distribution

Rollover the \$160,000 he received: This would result in only the \$40,000 being taxable. If Sherwood was under age 59½ when the distribution occurred, he will owe the IRS an early distribution penalty of \$4,000 ($\$40,000 \times 10$ percent) unless an exception applies.

²⁴ Treas. Reg. Section 1.401(a)(31)-1, Q&A-2.

²⁵ Treas. Reg. Section 1.401(a)(31)-1, Q&A-5.

²⁶ Treas. Reg. Section 1.402(a)(5)-1T and 1.402(c)-2, Q&A 13.

²⁷ IRC Section 3405(c); Treas. Reg. Section 31.3405(c)-1.

²⁸ Treas. Reg. Section 31.3405(c)-1, Q&A 2.

Rollover any amount less than \$200,000: This would result in the difference between the amount rolled-over and \$200,000 being treated as a taxable distribution for the year. If the amount is more than \$160,000, Sherwood would need to make up the difference between the amount and \$160,000 out of his regular savings.

In any case, the \$40,000 is reported on Sherwood's tax return as a payment of income taxes (taxes withheld) for the year the withholding occurred.

Note. State tax withholding may also apply. Specific state requirements must be reviewed separately as the state tax withholding rules are not the same for all states.

Practice Pointer: A participant who wants to avoid the 20 percent mandatory withholding on eligible rollover distributions must rollover the amount to a traditional IRA as a direct rollover. Any amount needed can then be distributed from the IRA, where the participant can choose whether to have taxes withheld.

Additional Withholding by Agreement

A distributee and plan administrator or payor are permitted to enter into an agreement to provide for withholding in excess of 20 percent from an eligible rollover distribution. Such an agreement is effective for such period as the parties mutually agree. Either party may also terminate the agreement by furnishing a signed written notice to the other party.²⁹

Withholding on Split Distributions

If an employee elects to have a portion of an eligible rollover distribution paid as a direct rollover to another plan and to receive the remainder of the distribution, mandatory withholding (20 percent) applies only to the portion of the distribution received by the individual and not to the portion paid as a direct rollover.³⁰

Property Distributions and Mandatory Withholding

If all or a portion of an eligible rollover distribution consists of property other than cash and is subject to the 20 percent withholding requirement, the employer must sell the property (except employer securities) in amounts sufficient to pay the withholding.³¹ No withholding is required if the eligible rollover distribution consists solely of employer securities and cash less than \$200.³²

Net Unrealized Appreciation in Employer Securities

An eligible rollover distribution can include net unrealized appreciation (NUA) from employer securities, even if the NUA portion is excluded from gross income. To the extent that the NUA portion of an eligible rollover distribution is excludible from gross income, the NUA portion is not a "designated distribution" subject to withholding because it is reasonable to believe that it is not includible in gross income.³³ To the extent that the NUA portion is excludible from gross income, the NUA portion is not included in the amount of an eligible

²⁹ Treas. Reg. Section 31.3405(c)-1, Q&A 3.

³⁰ Treas. Reg. Section 31.3405(c)-1, Q&A 6.

³¹ Treas. Reg. Section 31.3405(c)-1, Q&A 9, 10(d) and 11.

³² Treas. Reg. Section 31.3405(c)-1, Q&A 14.

³³ Treas. Reg. Sections 1.402(c)-2 Q&A 3(b)(3), 31.3405(c)-1, Q&A-12; IRS Notice 93-3, Section V.

rollover distribution that is subject to mandatory withholding. If the distribution consists solely of employer securities, no withholding is required.

Withholding on Distributions Not Eligible for Rollover

If the distribution does not qualify as an “eligible rollover distribution,” then withholding is based upon the voluntary withholding rules, including the employee’s ability to waive the withholding requirement.³⁴ The amounts to be withheld under the voluntary withholding rules differ, depending upon whether the distribution is a periodic or nonperiodic distribution. For periodic distributions, the wage withholding tables found in Circular E apply. For nonperiodic distributions, the rate of withholding is 10 percent; however, the employee can elect to have zero withholding, or withholding at a rate of more than 10 percent. The withholding rate cannot be less than 10 percent, unless it is zero.

Responsibility to Withhold

Generally, the plan administrator of a qualified plan and the payor of a 403(b) plan or 457(b) plan has the responsibility to perform any required withholding from plan distributions. However, the plan administrator may shift the burden of withholding to the payor by directing the payor to withhold and furnishing the payor with any information necessary to withhold the proper amount.³⁵

Traditional IRA Distributions Exception

The mandatory 20 percent withholding applicable to eligible rollover distributions from qualified plans, 403(b) arrangements and 457(b) plans does *not* apply to a distribution from an IRA. Under existing rules, withholding will generally apply to any IRA distribution at the rate of 10 percent, unless the payee elects to have no-withholding apply.³⁶ The payee can elect to have more than 10 percent withheld. The withholding rate cannot be less than 10 percent, unless it is zero.

\$200 *De Minimis* Rule

Employers may (but are not required to) exclude eligible rollover distributions that are reasonably expected to total less than \$200 during a year from the direct rollover option and the 20 percent mandatory withholding requirement. All eligible rollover distributions received within one taxable year under the same plan must be aggregated for purposes of determining whether the \$200 floor is reached.³⁷

Withholding Requirement on Property Distributions

If all or a portion of an eligible rollover distribution consists of property other than cash, employer securities, or plan loan offset amounts; and is subject to the 20 percent withholding requirement, the employer must sell the property (except employer securities) in amounts sufficient to pay the withholding. However, no withholding is required when the eligible rollover distribution consists solely of employer securities and cash amount of less than \$200.

³⁴ IRC Section 3405(a) and (b).

³⁵ Treas. Reg. Section 31.3405(c)-1, Q&A 4 and 5; Treas. Reg. Section 35.3405-1T, Q&A E-2 through E-5.

³⁶ Treas. Reg. Section 31.3405(c)-1, Q&A 1; Form 1099-R, *Instructions*.

³⁷ Treas. Reg. Sections 1.401(a)(31)-1, Q&A 11, 31.3405(c)-1, Q&A 14.

Payment of Withholding to Payor by Participant

If a distribution consists of property (other than employer securities), the payor or plan administrator could permit the payee to remit to the payor or plan administrator sufficient cash to satisfy the withholding obligation.

Distributions of Employer Securities

The maximum amount to be withheld on any designated distribution, including eligible rollover distributions, must not exceed the sum of the cash and the fair market value (FMV) of the property (excluding employer securities) received in the distribution. Although the value of employer securities is included in the amount that is multiplied by 20 percent, the amount to withhold from an eligible rollover distribution is limited to the sum of the cash and the FMV of property excluding employer securities. If the entire distribution represents employer securities and \$200 or less in cash, no withholding is required.

Distributions to Nonspouse Beneficiaries and Alternate Payees

Effective for distributions processed January 1, 2007 and after, distributions made to nonspouse beneficiaries can be rolled over from qualified, 403(b) and 457(b) plans to traditional inherited IRAs, if permitted under the plan. The IRA must be established in a manner that identifies it as an IRA with respect to a deceased individual and also identifies the deceased individual and the beneficiary, for example, “Tom Smith as beneficiary of John Smith.”

A plan is not required to offer a direct rollover of a distribution to a nonspouse beneficiary. If a plan does offer direct rollovers to nonspouse beneficiaries of some, but not all, participants, such rollovers must be offered on a nondiscriminatory basis because the opportunity to make a direct rollover is a benefit, right, or feature.

Distributions to beneficiaries are not subject to the 20 percent mandatory withholding requirement. Instead, distributions to nonspouse beneficiaries would be subject to the voluntary withholding rules.³⁸

If an alternate payee is a nonspouse with respect to a QDRO, such amounts are also not eligible rollover distributions. The plan participant is treated as the distributee and is subject to income taxes on any taxable amounts.³⁹

Practice Pointer: Because the distribution to a nonspouse alternate payee is includible in the gross income of the participant, no part of such distribution may be rolled over by the nonspouse alternate payee.^{40 41}

Reliance on Adequate Information Provided by the Employee

The plan administrator will not be subject to liability for taxes, interest, or penalties for failure to withhold income taxes from an eligible rollover distribution merely because the distribution is paid to an account or plan that is not an eligible retirement plan. Although the plan administrator is not required to verify independently the accuracy of information provided by the employee, the plan administrator’s reliance on the

³⁸ Treas. Reg. Section 1.402(c)-2, Q&A 12(b).

³⁹ IRC Section 402(a)

⁴⁰ IRS Notice 89-25, Q&A 4.

⁴¹ Treas Reg §1.402(c)-2, Q&A 12(b);

information furnished must be reasonable.⁴² The employee must furnish the necessary information to the plan administrator in order for a direct rollover to be accomplished. This includes providing the name and address of the recipient plan trustee or custodian.

Direct Rollovers

Direct Rollover Procedure

A direct rollover may be accomplished by any reasonable means of delivery to the new eligible retirement plan, including a wire transfer or the mailing of a check to the new recipient plan. If payment is made by check, the check must be negotiable only by the trustee or issuer of the recipient plan. If payment is made by wire transfer, the wire transfer may only be directed to the trustee or issuer of the recipient plan. The delivery of a check to the new plan by the employee is also permitted, provided that the payee line of the check is made out in a manner that will ensure that the check is negotiable solely by the trustee or custodian of the recipient plan.⁴³ A direct rollover payment should be made payable as follows:

[Name of trustee/custodian] as [trustee/custodian] FBO [name of participant] [name of recipient plan]

An example is, "GalacticBank as Trustee FBO William Jefferson Clinton, IRA."

Other slight variations are acceptable, providing it is clear which party is the trustee/custodian and which party is the IRA owner.

If the recipient plan is not an IRA, the payee line of the check need not identify the trustee by name. For example, a check may read "Trustee of XYZ Corporation Profit Sharing Plan FBO Jane Doe" if such direct rollover is being made to that plan.

Caution: *Do not issue direct rollover payments to broker-dealer, as payee, that are not the named custodian or trustee of the recipient plan.*⁴⁴

Splitting Distributions Under the \$500 Rule

An employer must permit an employee to elect to have a portion of an eligible rollover distribution paid in a direct rollover to another plan and have the remaining amount paid directly to the employee. However, the employer need not follow this requirement if the portion to be paid in a direct rollover to another plan is less than \$500 or if the entire rollover eligible amount is \$500 or less.⁴⁵

Direct Rollovers to Multiple Recipient Plans

An employer may but is not required to permit the employee to elect a direct rollover into more than one recipient plan. Thus, the plan administrator may require that the distributee select a single plan to which the eligible rollover distribution (or portion thereof) will be paid in a direct rollover.

Example. An employer's plan requires an employee to select one traditional IRA into which the entire eligible rollover distribution will be paid. The employee could then directly transfer from that traditional IRA

⁴² Treas. Reg. Section 31.3405(c)-1, Q&A 7.

⁴³ Treas. Reg. Section 1.401(a)(31)-1, Q&A 3 & 4.

⁴⁴ Treas. Reg. Section 1.401(a)(31)-1, Q&A 3 & 4.

⁴⁵ Treas. Reg. Section 1.401(a)(31)-1, Q&A 9.

a portion of the traditional IRA to another plan to achieve the desired result.⁴⁶ The one-rollover per year rule only applies to rollovers between IRAs; it does not apply to rollovers between qualified plans/403(b)/457(b) plans and IRAs.

Election Deadline and Default Procedure

A plan administrator is permitted to establish a default procedure in the event a distributee does not make an affirmative election to make or not to make a direct rollover.⁴⁷ The default procedure can include, for example, that if the distributee does not make the affirmative election within 90 days of the IRC Section 402(f) Notice, such amount will be distributed subject to the 20 percent withholding or that such amount will be automatically distributed in a direct rollover to an eligible recipient plan. If the plan administrator wishes to have such a default procedure, such default must either be part of the 402(f) Notice or a separate explanation that must be received by the distributee in conjunction with the 402(f) Notice.

The employer is also permitted to establish a deadline after which the employee may not revoke an election to make or not to make a direct rollover. However, such a deadline may not be more restrictive than that which otherwise applies under the plan to revoke the form of distribution elected by the participant.

An employer may treat the employee's election to make or not to make a direct rollover with respect to one payment in a series of periodic payments which qualify as eligible rollover distributions as applying to all payments in the series if:

- The employee may change the election at any time with respect to subsequent payments; and
- The required 402(f) Notice explains that the election to make or not to make a direct rollover will apply to all future payments which are eligible rollover distributions unless the employee changes the election.

Practice Pointer: The employer may not make a distribution under the default procedure unless (1) the distributee has received an explanation of the default procedure and an explanation of the direct rollover option as required under Code Section 402(f) and (2) the timing requirements for both explanations have been satisfied.⁴⁸

Prohibition Against Employer Impairing a Direct Rollover

An employer or plan administrator may not in any way impair the employee's availability of electing a direct rollover. Impermissible procedures include:⁴⁹

1. Requiring the distributee to obtain an attorney's opinion that the eligible retirement plan receiving the rollover is an eligible recipient plan
2. Requiring the recipient plan that, upon request, the plan will automatically return any direct rollover amount that the distributing plan advises the recipient plan was paid incorrectly
3. Requiring the recipient plan to provide a letter indemnifying the distributing plan for any liability arising out of the distribution

⁴⁶ Treas. Reg. Section 1.401(a)(31)-1, Q&A 10.

⁴⁷ Treas. Reg. Section 1.401(a)(31)-1, Q&A 7 and 8.

⁴⁸ Treas. Reg. Section 1.401(a)(31)-1, Q&A-7

⁴⁹ Treas. Reg. Section 1.401(a)(31)-1, Q&A 6.

If too much is rolled over to an IRA, the ineligible amount should be treated as a contribution to a traditional IRA, subject to the annual contribution limit under IRC Section 219. If the rollover results in an excess contribution to the IRA, it must be corrected as provided under IRC Section 408(d)(4) along with the earnings attributable to the excess amount in order to avoid the 6 percent excise tax. Excess amounts remaining in the IRA after the applicable deadline will be subject to the 6 percent excise tax for every year it remains in the IRA.

IRC Section 402(f) Notice

The IRS provides a model notice and safe-harbor explanation for employers and plan administrators to use to satisfy the required IRC Section 402(f) notification to recipients of eligible rollover distributions. The 402(f) Notice may not be posted, and must instead be provided to each individual distributee of an eligible rollover distribution within the prescribed time period.⁵⁰ The IRC Section 402(f) Notice must be designed to be easily understood and must contain a written explanation of:⁵¹

1. The availability of the direct rollover option
2. The rules that require income tax withholding on eligible rollover distributions which are not paid in a direct rollover to an eligible plan
3. The rules under which the distributee may roll over the distribution within 60 days of receipt
4. If applicable, the other special tax rules (for example, grandfathered 10-year averaging) that may apply to the distribution, including treatment of net unrealized appreciation on employer securities

An employer may use the word-for-word identical language provided by the IRS, or the employer may customize the notice by omitting those provisions that do not apply under the employer's plan. Employers may also add additional language to the notice as long as the additional information is not inconsistent with the safe harbor notice or IRC Section 402(f).

The employer/plan administrator is required to provide the safe-harbor notice "within a reasonable time" before making an eligible rollover distribution. *Reasonable time* has been defined to be generally no less than 30 days and no more than 90 days before the distribution date. However, employees may waive the application of the 30-day "holding" period by making an "affirmative election" to make or not make a direct rollover providing that:

- The participant is given at least 30 days to decide.
- The plan administrator states in writing that the participant has a right to the 30-day period to make the decision. An obvious place for this statement is on the 402(f) Notice. The written notice must be provided individually to any distributee of an eligible rollover distribution.⁵²

With respect to a series of periodic payments that are eligible rollover distributions, (that is, total payments less than 10 years), the plan administrator is required to distribute the 402(f) Notice prior to the first payment and generally provide the notice at least once annually for as long as the payments continue.⁵³

⁵⁰ Treas. Reg. Section 1.402(f)-1, Q&A 4.

⁵¹ Treas. Reg. Section 1.402(f)-1, Q&A 1.

⁵² Treas. Reg. Section 1.402(f)-1, Q&A 4.

⁵³ Treas. Reg. Section 1.402(f)-1, Q&A 3. See exceptions to one year rule.

For returns, reports, and other statements which are due for years after December 31, 1996, the plan administrator is subject to a \$100 penalty (\$50,000 maximum per year) for each failure to provide the 402(f) Notice at such time and in such manner as required.

Model 402(f) Notices for Qualified Plans and 403(b)s

Model notices explaining pension rollover right were issued in Notice 2002-3.⁵⁴ There is a separate 402(f) Notice for 457(b) plans. In Announcement 2002-46, the IRS provided a safe-harbor explanation in Spanish that plan administrators can provide to Spanish-speaking employees who are recipients of eligible rollover distributions from qualified employer plans, tax-sheltered annuities or governmental section 457(b) plans to satisfy IRC Section 402(f).⁵⁵

Rollovers and Direct Rollovers by Surviving Spouse Beneficiaries

If a surviving spouse beneficiary of a deceased plan participant receives an eligible rollover distribution, all of the rollover and direct rollover provisions generally apply as if the surviving spouse were the participant. Thus, the surviving spouse beneficiary can rollover the amount to a traditional IRA or have the amount moved to a qualified plan, 403(b) account or 457(b) plan as a direct rollover, providing the plan accepts such rollovers.⁵⁶

Rollovers and Direct Rollovers by Alternate Payee Under a QDRO

If a spouse or former spouse of a plan participant is to be treated as the recipient of an eligible rollover distribution pursuant to a QDRO (usually in connection with a divorce or similar proceeding), such alternate payee is treated under the same rules as the plan participant for purposes of a rollover or direct rollover. This also includes the ability of the alternate payee spouse or former spouse to elect a direct rollover into another employer's plan of the alternate payee that accepts such rollovers or to a traditional IRA.⁵⁷

The Recipient Plan Is Not Required to Accept the Funds

Although the employer's plan must provide employees the option to elect a direct rollover of an eligible rollover distribution to another eligible plan, there is no requirement that the recipient plan accept such direct rollovers.⁵⁸ Thus, a recipient plan can refuse to accept rollovers and direct rollovers. In addition, a recipient plan can limit the circumstances under which it will accept rollovers and direct rollovers. For example, a recipient plan can limit the types of plans from which it will accept a rollover or direct rollover, or limit the types of assets it will accept in a rollover (such as only cash).

Practice Pointer: The plans that are usually designed to limit the types of plans from which they will accept rollovers usually do not include IRAs. Instead, IRA agreements are usually written to accept rollover-eligible amounts from all eligible retirement plans.

⁵⁴ 2002-2 IRB 289.

⁵⁵ 2002-28 IRB 96.

⁵⁶ IRC Section 402(c)(9) and Treas. Reg. Section 1.402(c)-2, Q&A 12(a).

⁵⁷ IRC Section 402(e)(1)(B) and Treas. Reg. Section 1.402(c)-2, Q&A 12(a).

⁵⁸ Treas. Reg. Section 1.401(a)(31)-1, Q&A 13.

Plan Must Allow for a Distribution

The expanded portability rules do not require that a distribution be made, but instead expanded the types of plans between which rollovers may be made. The employer's qualified plan must permit distributions to be made upon participants becoming eligible to make withdrawals. For example, profit-sharing plans may allow for in-service distributions, while money-purchase plans may only provide for a distribution after retirement or other triggering event.

IRS Reporting

Although a *direct rollover* is being paid from an employer's plan directly to an IRA or another eligible retirement plan (that is, the employee is not in actual receipt of the distribution), it is still treated as a reportable distribution and subsequent rollover to another plan.⁵⁹

Practice Pointer: A direct rollover is a two part transaction (1) the distribution and the rollover contribution. The distribution is reported on IRS Form 1099-R, with code G in box 7 to denote that the amount was processed as a direct rollover from the delivering plan. If the recipient plan is an IRA, a Form 5498 is used to report the rollover.

Disqualification Relief for Plans Accepting Direct Rollovers

Treasury Regulations provide relief from disqualification if the plan accepts a defective rollover, but only if the following requirements are satisfied:⁶⁰

1. *Direct Rollover From Another Qualified Plan.* A letter from the distributing plan should be received which provides that either:
 - a. The distributing plan has received an IRS determination letter (but the recipient plan is not required to receive a copy of the determination letter); or
 - b. The distributing plan satisfies (or is intended to satisfy) IRC Section 401(a), and the plan administrator is not aware of any provision or operation that would result in disqualification.
2. *60-Day Rollover Received From the Participant.* The participant must certify that, to the best of the participant's knowledge:
 - a. The participant was entitled to the distribution as an employee, not as a beneficiary.
 - b. The distribution was not one of a series of periodic payments.
 - c. The distribution was received not more than 60 days before the rollover contribution.
 - d. The entire amount being rolled over would have been taxable had it not been rolled over.
3. *Rollover From a Conduit IRA.* The participant must also certify that the rollover into the conduit IRA:
 - a. Was made not more than 60 days after the employee received the original distribution.
 - b. No amounts other than the qualified plan distribution were contributed to the conduit IRA (unless the plan accepts rollovers from other types of plans).
 - c. The rollover contribution made to the new qualified plan was made within 60 days after the distribution from the conduit IRA.

⁵⁹ Treas. Reg. Section 31.3405(c)-1, Q&A 15, 16, 17.

⁶⁰ Treas. Reg. Section 1.401(a)(31)-1, 1.402(c)-2.

If a plan accepts a defective rollover, the receiving plan will not be disqualified, if the following two conditions are met. First, the plan administrator of the receiving plan reasonably concludes that the contribution is a valid rollover (based upon the above criteria). Second, the plan administrator of the receiving plan distributes the invalid rollover amount, plus any earnings, to the employee within a reasonable time after the rollover was determined to be invalid.

Default Direct Rollovers Upon Involuntary Cash-out

A qualified plan may provide that upon the occurrence of certain events, such as death or if the employee separates from service with the employer, the employee's vested balance of \$5,000 or less under the plan may be distributed without the participant and his/her spouse's written consent under certain circumstances. This is referred to as an involuntary cash-out. In instances where the cash-out amount is between \$1,000 and \$5,000, the amount must be processed as a direct rollover to a traditional IRA, instead of being distributed to the participant.⁶¹ Notice 2001-57 includes sample amendment, and administrative and procedural guidance.

Practice Pointer: If the plan is subject to the qualified joint and survivor annuity (QJSA) and qualified preretirement survivor annuity (QPSA) payout requirements, no cash-out can be made after the annuity starting date without the participant and, if applicable, spouse's consent.

When determining the participant's balance for cash-out purposes, the employer may disregard amounts attributable to a rollover contribution (and applicable earnings) to the plan.

Example. An employer maintains a defined contribution plan that allows rollover contributions from other retirement plans. JT rolled over \$50,000 to his account and now has a balance of \$53,000. The plan may cash-out JT's balance, even though it is more than \$5,000, because the plan is designed to disregard rollover amounts for purposes of the cash-out rule. The balance would be processed as a direct rollover to a traditional IRA, unless JT elects otherwise.

Practice Pointer: If an employer does not want to rollover cash-out amounts to IRAs, the plan may be amended to reduce the cash-out limit to \$1,000. This would result in all cash-out amounts being distributed directly to the participant, instead of as a direct rollover to an IRA. The employer can also eliminate the cash-out requirement.

For plans with cash-out threshold more than \$1,000, the plan administrator must follow certain safe harbor fiduciary actions when choosing the custodian/trustee for the IRA to which the cash-out amount will be rolled over. In general, the plan administrator is provided safe harbor relief if the following requirements are met:

1. The amounts must be directly rolled over to an IRA annuity or account.
2. Plan fiduciaries enter into a written agreement with the IRA custodian/trustee, wherein the trustee/custodian provide "the fiduciary can rely on commitments of the [IRA] provider . . . 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. . ."
3. The agreement must address the following:

⁶¹ Rev. Rul. 2000-36 (2000-2 C.B. 140).

- a. Any assets in which the rolled over amount is invested must be investments which will preserve the principal amount, and provide a reasonable rate of return. The rate of return need not be guaranteed. This includes money market funds, interest-bearing savings accounts, certificates of deposit, and other "stable value products."
 - b. The investment must be offered by a state or federally regulated financial institution, such as a bank, saving association, credit union, insurance company, or registered Investment Company.
 - c. The fees charged by the IRA custodian/trustee cannot exceed the fees charged for comparable rollover to other IRAs.
 - d. The terms of the IRA agreement must be enforceable by the IRA owner.
 - e. The employer must provide the plan participant with an amended Summary Plan Description (SPD) or Summary of Material Modification (SMM) that includes the plan's procedures for automatic rollovers. This includes an explanation of how the assets will be invested, applicable fees, and the name, address and phone number of a "plan contact" for the custodian/trustee.
4. Participants have been furnished a summary plan description (SPD), or a summary of material modifications (SMM), that describes the plan's automatic rollover provisions, including 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; and the name, address and phone number of a plan contact.
 5. Both the fiduciary's selection of an IRA and the investment of funds would not result in a prohibited transaction under section 406 of the Act, unless such actions are exempted from the prohibited transaction provisions by a prohibited transaction exemption issued pursuant to section 408(a) of the Act.

Responsibilities of Employer and IRA Trustees

A default direct rollover provision for involuntary cash-outs must be described in the summary plan description, the plan document, and the IRC Section 402(f) Notice. The 402(f) Notice must also contain the name, address, and telephone number of the IRA trustee or custodian, and describe any maintenance or withdrawal fees imposed by the IRA and how funds will be invested. A default direct rollover must not occur for less than 30 days and not more than 90 days after the date the 402(f) Notice is given to the participant.

The employer is also permitted to establish a deadline after which the employee may not revoke an election to make or not to make a direct rollover. However, such a deadline may not be more restrictive than that which otherwise applies under the plan to revoke the form of distribution elected by the participant.⁶²

The employer may execute the IRA paperwork on behalf of the participant. A similar rule applies for SEP plans and SIMPLE IRAs if the participant refuses to set up an IRA or cannot be found.⁶³ Not all IRA trustees or custodians will allow an employer to establish an IRA on behalf of an employee. It is incumbent upon an employer under such circumstances to find an IRA trustee or custodian that will accept a default direct rollover before completing the required notice.

⁶² See, IRC Section 401(a)(31)(B). On January 7, 2003, the DOL issued proposed rules on automatic default rollovers (68 Fed. Reg. 4, 991-994). Section 657(c) of the EGTRRA 2001 directed the DOL to develop, through regulations, safe harbors relating to the automatic rollovers of certain mandatory tax-qualified plan distributions to individual retirement plans. Under these safe harbors, the designation of an institution and the investment of funds by a plan administrator to receive automatic rollovers in accordance with IRC Section 401(a)(31)(B) would be deemed to satisfy the fiduciary requirements of ERISA Section 404(a).

⁶³ Prop. Treas. Reg. Section 1.408-7(d)(2).

Disregarding Rollovers for Purposes of the \$5,000 Cashout Limit

A plan is permitted to exclude rollover balances (including earnings) in determining whether or not a participant's benefit exceeds \$5,000 for purposes of the involuntary cash-out rules of IRC Section 411(a)(11).

Related Rollover and Direct Rollover Issues

Lump-Sum Distributions from Qualified Plans

Although Congress modified and expanded the types of eligible rollover distributions and implemented the direct rollover option and the 20 percent mandatory withholding requirement, taxpayers may still be eligible for favorable tax treatment (10-year averaging and/or capital gains) on certain lump-sum distributions from qualified plans.⁶⁴ See Chapter 4, "Qualified Plans in General," for more information.

60-Day Rollover Requirement

If an eligible rollover distribution is paid to the recipient rather than paid as a direct rollover to another plan, the eligible amounts can still be rolled over. The rollover contribution must be made, however, no later than the sixtieth calendar day *after* the distribution was actually *received* by the individual (not the date on the check). The 60-day rollover period applies separately to *each* eligible rollover distribution as it is received by the distributee.⁶⁵ The date of receipt is determined by the recipient and need not be proved by the receiving plan's trustee or custodian. If the sixtieth day falls on a weekend or legal holiday, the rollover must be completed no later than the next business day immediately following the weekend or legal holiday.

The employer or payor is required to withhold 20 percent of the eligible rollover distribution that was paid to the recipient. Since the 20 percent withheld amount is considered part of the eligible rollover distribution, the individual may include an amount equal to the amount that was withheld in order to roll over the entire taxable amount of the distribution. The individual would need to make up this amount from his/her regular savings.

Example. TJ is expected to receive a distribution from his qualified plan account in the amount of \$200,000. This entire amount is fully taxable upon distribution and qualifies as an eligible rollover distribution. TJ elects to have the distribution paid to him, instead of having it processed as a direct rollover to an eligible retirement plan. TJ's employer must withhold and remit 20 percent of the distribution to the Department of the Treasury. The payer must issue a copy of IRS Form 1099-R to TJ, which will show the \$200,000 as a taxable distribution and that \$40,000 was withheld for federal income tax. If TJ chooses to roll over the distribution within the required 60-day period, he may do the following:

Rollover the entire \$200,000: To do so, he will need to make up the \$40,000 out of his regular savings. This would result in the \$200,000 being a nontaxable distribution.

Rollover the \$160,000 he received: This would result in only the \$40,000 being taxable. If Sherwood was under age 59½ when the distribution occurred, he will owe the IRS an early distribution penalty of \$4,000 (40,000 × 10 percent), unless an exception applies.

⁶⁴ IRC Section 402(d), repealed for tax years after December 31, 1999.

⁶⁵ IRC Section 402(c)(3); Treas. Reg. Section 1.402(c)-2, Q&A 11.

Rollover any amount less than \$200,000: This would result in the difference between the amount rolled over and \$200,000 being treated as a taxable distribution for the year. If the amount is more than \$160,000, Sherwood would need to make up the difference (between the \$160,000 and the amount rolled over) out of his regular savings.

In either case, the \$40,000 is reported on TJ's tax return as a payment income tax (tax withholding) for the year the withholding occurred.

Exception for Frozen Deposits

The 60-day rollover period described above is extended if the individual is unable to withdraw the funds due to the money becoming frozen after the distribution is received but before the rollover is completed. The term *frozen deposit* means any deposit which may not be withdrawn because of the bankruptcy or insolvency (or threat thereof) of any financial institution. The 60-day period will not include any period during which the deposit is frozen or end earlier than 10 days after such amount ceases to be a frozen deposit.⁶⁶

Exception for Certain Disasters

A taxpayer's 60-day rollover period may be extended in cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to the rollover period.⁶⁷

Waiver of 60-Day Rule

The IRS may waive the 60-day requirement if the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. In determining whether to grant a waiver of the 60-day rollover requirement, the IRS will consider all relevant facts and circumstances, including:⁶⁸

- Errors committed by a financial institution
- Inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error
- The use of the amount distributed (for example, in the case of payment by check, whether the check was cashed)
- The time elapsed since the distribution occurred

The taxpayer is not required to submit an application (by private letter ruling) to the IRS, providing:

1. A financial institution receives funds on behalf of a taxpayer prior to the expiration of the 60-day rollover period.

⁶⁶ IRC Section 402(c)(7).

⁶⁷ IRC Sections 402(c)(3)(B), 408(d)(3)(I).

⁶⁸ IRC Sections 408(d)(3)(A)(ii) (the 60-day rule), 408(d)(3)(D) (partial rollovers permitted within 60 days), 408(d)(3)(I) (waiver of 60-day requirement); Rev. Proc. 2003-16, 2003-4 IRB 359; Rev. Proc. 2003-1, 2003-1 IRB 1 (procedures for issuing letter rulings); Rev. Proc. 2003-8, 2003-1 IRB 236 (user fee schedule); Ltr. Ruls. 200401020 and 200401023 (financial institution error), 200401024 (mental illness based on principles of equity or good conscience), 20040102 (Incapacity due to Alzheimer's disease).

2. The taxpayer follows all procedures required by the financial institution for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan).
3. Solely due to an error on the part of the financial institution, the funds are not deposited into an eligible retirement plan within the 60-day rollover period.

Automatic approval is granted only if:

1. The funds are deposited into an eligible retirement plan within one year from the beginning of the 60-day rollover period
2. It would have been a valid rollover had the financial institution deposited the funds as instructed.

Distribution of Property

In general, if an eligible rollover distribution consists of both cash and property (such as stock), the assets rolled over must consist of the same property distributed. Unlike property distributions from IRAs, property distributed from an employer's plan may be sold and the proceeds from the sale may be rolled over.⁶⁹ However, the proceeds from the sale would be used to determine the maximum amount eligible for rollover, whether it is more or less than the FMV of the property on the date of distribution.

Fluctuations in Fair-Market Values

In most cases involving property distributions, the value of the property at the time of distribution (for purposes of Form 1099-R) is different from the value of the property (or the proceeds from the sale of the property) on the date of the rollover contribution (for purposes of Form 5498). The taxpayer is still responsible for properly reflecting a rollover on his or her federal income tax return. Therefore, the person's tax preparer should probably provide a line item explanation and attach it to the appropriate year's return identifying the possible reasons why the Forms 1099-R and 5498 do not match.

Replacing Distributed Property with Cash

The recipient of an eligible rollover distribution may not retain the property distributed and roll over cash representing the FMV of the property. The property rolled over must either be the actual property received in the distribution, or the proceeds from the bona fide sale of the distributed property.⁷⁰

Net Unrealized Appreciation in Employer Securities Distributed from a Qualified Plan

Although the plan's cost basis for purposes of determining the NUA may be composed of varying costs of shares purchased in different years, the shares distributed have a new basis which is the same for each share received in the same distribution.⁷¹ This new basis would be used for purposes of determining gains or losses on a subsequent sale or other taxable disposition of the assets.⁷²

⁶⁹ IRC Section 402(c)(6).

⁷⁰ Rev. Rul. 87-77.

⁷¹ IRC Section 402(e)(4); Treas. Reg. Sections 1.402(c)-2 Q&A 3(b)(3), 31.3405(c)-1, Q&A 12.

⁷² Rev. Rul. 57-114.

Even if the net unrealized appreciation portion of a distribution is excluded from gross income, the NUA would be included as part of an eligible rollover distribution. However, to the extent that the NUA portion is excludible from gross income, the NUA portion is not a “designated distribution” subject to withholding, because it is reasonable to believe that it is not includible in gross income. As a result, to the extent that the NUA portion is excludible from gross income, the NUA portion is not included in the amount of an eligible rollover distribution that is subject to the 20 percent withholding requirement. Therefore, if the distribution consists solely of employer securities and \$200 or less in cash in lieu of fractional shares, no withholding is required.

Although a rollover (including a direct rollover) will make a lump-sum distribution ineligible for forward income averaging,⁷³ there is no similar prohibition in the rules that provide for exclusion of NUA from income. The IRS has expressly ruled that a rollover of the other assets received in a lump-sum distribution, even if through a direct rollover, will not preclude the participant from deferring recognition of the NUA in the shares retained (not rolled over).⁷⁴

A rollover of some of the employer securities is possible. If the participant rolls over some of the employer securities, then a pro-rata allocation of the NUA, based on the number of shares retained, should be allocated to the securities which are not rolled over.⁷⁵

Example. Darleen receives a lump-sum distribution from her employer's qualified plan. The distribution consists of 100 shares of her employer securities. The average cost basis of each share in the plan's trust is \$50, and the FMV on the date of distribution is \$100. The possible outcomes are as follows:

1. Darleen rolls over the 100 shares to a traditional IRA. She will lose NUA treatment. Her distribution from the IRA will be fully taxable.
2. Darleen decides to keep 50 shares and rollover the remaining 50 shares to a traditional IRA. She will lose NUA treatment on the shares rolled over. The shares that were not rolled over will continue to retain their individual average cost basis of \$50.
3. Darleen decides to retain the full amount of the NUA by keeping 50 shares having a value equal to the total NUA of \$5,000 ($50 \times \100) and rolling over the remaining 50 shares. Darleen cannot attribute the NUA to specific shares. Darleen will lose NUA treatment on the shares rolled over. The shares that were not rolled over will continue to retain their individual average cost basis of \$50.

Distributions Other Than Lump Sum

Generally, the exclusion of NUA is not available for distributions that are not lump-sum distributions. However, to the extent that after-tax employee contributions were made by the employee, the exclusion of NUA is available only on the NUA resulting from employee contributions, other than deductible voluntary employee contributions.

Qualifying Lump-Sum Distributions That Include After-Tax Employee Contributions

A participant who has made after-tax employee contributions and receives a qualifying lump-sum distribution of employer securities must keep track of the value of the after-tax employee contributions if such stock is rolled over to a traditional IRA. This value increases the taxpayer's basis in his or her IRA for de-

⁷³ IRC Section 402(d)(4)(K).

⁷⁴ Ltr. Rul. 9721036 (Feb 27, 1997); Ltr. Rul. 200003058 (Oct. 29, 1999)

⁷⁵ Ltr. Rul. 200038057.

termining subsequent taxable IRA distributions. The taxpayer must file IRS Form 8606 for the rollover of after-tax amount. Form 8606 must also be filed for any year the IRA owner has after-tax amounts or amounts attributable to nondeductible IRA contributions, and a distribution occurs from any of his/her traditional, SEP or SIMPLE IRA. Form 8606 includes a built-in formula that determines how much of the distribution would be taxable.

Rolling Over All Securities Except the Portion Representing After-Tax Contributions

A participant who receives employer securities in a qualifying lump-sum distribution and who has made nondeductible employee contributions must allocate the NUA between employee and employer contributions.

Example. Ryan receives a lump-sum distribution with a total FMV of \$46,000. This amount consisted of \$4,000 in cash and \$42,000 in company stock. The cost basis of the stock is \$24,000, and the NUA is \$18,000. Ryan made \$10,000 nondeductible employee contributions to the plan. The total taxable amount of the distribution is \$18,000, computed as follows:

$$\begin{aligned} & \$4,000 \text{ cash} + \$42,000 \text{ stock FMV} - \$18,000 \text{ NUA} \\ & - \$10,000 \text{ nondeductible employee contributions} = \$18,000 \end{aligned}$$

Since the total cost of the stock was \$24,000, \$10,000 of which represented the employee's nondeductible contributions, the amount is attributable to the employee's contributions can be computed as follows:

$$5/12 (\$10,000 / \$24,000) \times \$18,000 = \$7,500$$

The remaining \$10,500 (\$18,000 – \$7,500) is attributable to contributions made by Ryan's employer.

If Ryan wants to roll over the taxable amount but recognize the deferral of NUA on his after-tax contributions, he would need to roll over the \$4,000 cash, plus \$24,500 of the stock (\$24,000 total cost basis at distribution – \$10,000 after-tax employee contributions + \$10,500 NUA value on employer contributions). In this example, the resulting basis in the stock not rolled over is \$10,000, and the NUA attributable to the nondeductible employee contributions is \$7,500. Upon a subsequent sale of the stock, \$7,500 is taxed at the long-term capital gains rate and any additional gain is taxed at either the short- or long-term capital gains rate depending upon the actual holding period since the stock was distributed to Ryan from the plan.

Stepped-Up Basis of Employer Stock Held Until Death

If an employee receives a qualifying distribution of employer securities and the NUA is excluded from the employee's gross income (as discussed above), the basis in the stock going forward is the value that was taxed upon distribution (the plan's original cost basis of the stock).

At the employee's death (assuming that the stock is still being held by the individual at that time), the stepped-up basis rules provide that only the appreciated value of the employer stock after it was distributed from the plan receives a step-up in basis when the heirs, subsequent to the employee's death, sell the stock. The IRS has ruled that the original NUA that was excluded from the employee's gross income when it was first distributed from the plan does not receive a step-up in basis. Thus, the NUA retains its original character even after the employee's death, and will constitute income in respect of a decedent when the heirs sell the stock.⁷⁶

⁷⁶ Rev. Rul. 75-125.

Example. Butch received a qualifying lump-sum distribution from his employer's qualified plan that consisted entirely of employer securities. On distribution, the FMV of the stock was \$100,000 and had a cost basis of \$20,000. The NUA portion of the stock distributed was \$80,000. Butch included in gross income the cost basis of \$20,000 and excluded the NUA portion of \$80,000.

Butch still held the employer's stock upon the date of his death. On his date of death, the stock had appreciated in value to \$140,000. If Butch's heirs decide to sell the stock several months later, the stock was worth \$150,000. The stepped-up basis for the heirs when the stock is sold is \$60,000 (\$140,000 date of death value – \$80,000 NUA). The \$80,000 NUA is included in the gross income of the heirs, but the heirs may be able to take a tax deduction on their federal income tax return as income in respect of a decedent.

The additional \$10,000 gain from the date of Butch's death to the date his heirs sold the stock is also included in the gross income of the heirs. Thus, \$90,000 (\$80,000 NUA + \$10,000 additional gain) is taxable to the heirs as long-term capital gains.

No Rollover and Direct Rollover of Amounts Subject to Required Minimum Distribution Rules

Any amount which is required to be distributed under IRC Section 401(a)(9) is not an eligible rollover distribution. The first distribution during a year for a required minimum distribution (RMD) is treated as the RMD amount from that plan, to the extent the RMD has not been satisfied and are not eligible to be rolled over to another plan.⁷⁷

Thus, if RMD amounts are rolled over or paid as a direct rollover to another retirement plan, the taxpayer is subject to income taxes on any taxable amount without regard to the rollover. And if the recipient plan is an IRA, the RMD is treated as an excess IRA contribution, which must be corrected under IRC Section 408(d)(4). Any amount not removed from the IRA by the deadline is subject to the 6 percent excise tax each year until the excess amount is removed from the IRA.

If a participant has not received his or her RMD prior to receiving an eligible rollover distribution and a portion of the distribution is excludible from gross income (nondeductible employee contributions), then the portion of the distribution that is excludible from gross income is first allocated toward the RMD amount.⁷⁸ This has the result of allowing the participant to roll over more of the taxable portion.

Example. Nick, a participant in a qualified plan is eligible to receive a \$4,800 distribution, \$4,000 of which is his required minimum distribution (RMD) for the year. The administrator determines that \$1,000 of the distribution is excludible from gross income for the year due to the return of nondeductible employee contributions. First, the \$1,000 return of basis is allocated toward satisfying the RMD. Then the remaining \$3,000 of the RMD is satisfied from the \$3,000 of the distribution that is includible in gross income. This leaves the remaining amount of \$800 as an eligible rollover distribution if it otherwise qualifies.

Plan Administrator May Make Certain Assumptions

A plan administrator is permitted to determine the amount of a RMD for any calendar year by assuming that there is no designated beneficiary.⁷⁹ This means that the "Uniform Lifetime Table" (previously known as the MDIB table) would be used to determine the RMD amount. Although the plan administrator calculates the RMD by assuming that there is no designated beneficiary, the portion of the distribution that is actually a

⁷⁷ IRC Section 402(c)(4)(B); Treas. Reg. Section 1.401(a)(9)-7 and IRS Notice 93-3.

⁷⁸ Treas. Reg. Section 1.402(c)-2, Q&A 8.

⁷⁹ Treas. Reg. Section 1.401(a)(31)-1, Q&A 17(c) and 1.402(c)-2, Q&A 15.

RMD and is not an eligible rollover amount is determined by taking into consideration the designated beneficiary, if any. Therefore, if a greater portion of the distribution is an eligible rollover distribution by taking into account the designated beneficiary, the distributee may roll over the additional amount.

Withdrawing More Than the Minimum

Any payments which exceed the RMD amount are eligible rollover distributions (unless another exception applies) and thus could be subject to the 20 percent withholding. The portion representing the RMD is subject to the voluntary withholding rules:

If a participant in an individual account plan is required under 401(a)(9) to receive a RMD for a calendar year of \$1,000 and the participant receives four quarterly distributions in that year of \$400 each, then the first two distributions and \$200 of the third distribution are not eligible rollover distributions. However, the remaining \$200 of the third distribution and all of the fourth distribution are eligible rollover distributions because this is the amount by which the total of the distributions exceeds the RMD.⁸⁰

Direct Rollover Can Be Immediately Rolled Again

The restriction of only one rollover within a 12-consecutive month period applies *only* to rollovers between IRAs.⁸¹ Therefore, if a rollover or direct rollover is made from an employer's plan into an IRA, the IRA holder can immediately roll (or direct transfer) that IRA into another IRA. As a matter of fact, the individual could even "revoke" the newly established IRA within the first seven days, and the IRA trustee or custodian would not be allowed to charge any fees, although the revoked distribution would be reportable on Form 1099-R as fully taxable. This is true even though the participant had to irrevocably elect to treat the original rollover or direct rollover to the IRA as a rollover contribution.⁸²

Participant Loans Treated as Distributions

Participant loans in an employer plan can produce two types of distributions; a deemed distribution of a loan in default or a distribution of a loan offset amount.⁸³

A *deemed distribution* occurs if IRC requirements governing participant loans (for instance, amount of repayment, frequency of payments, and so on) are not satisfied. Such deemed distribution is treated as a distribution for federal income tax purposes and not as a distribution of the participant's accrued benefit under the plan. In general, a deemed distribution is not an eligible rollover distribution, and, therefore, is not subject to the 20 percent withholding requirement.

Example. Timothy has a balance of \$20,000 in his employer's plan. \$6,000 is invested in a participant loan. If Timothy defaults on the loan by not making a loan payment under the terms of the plan or loan policy, \$6,000 is a deemed distribution subject to federal income taxes. However, this \$6,000 deemed distribution is not an eligible rollover distribution and not subject to the 20 percent mandatory withholding. Timothy will receive a Form 1099-R indicating the defaulted loan amount as taxable.

A *distribution of an offset amount* occurs if, under the terms of the plan or the plan's loan policy, the participant's accrued benefit under the plan is reduced (offset) in order to pay off the loan. Such an offset could occur, for example, in the case of a participant separating from service or requesting a distribution

⁸⁰ IRS Notice 93-3.

⁸¹ IRC Section 408(d)(3)(B); Treas. Reg. Section 1.402(c)-2, Q&A 16.

⁸² Pursuant to Treas. Reg. Section 1.402(a)(5)-1T.

⁸³ Treas. Reg. Sections 1.402(c)-2, Q&As 4(d) and 9, 1.401(a)(31)-1, and Q&A 15 and IRS Notice 93-3.

from the plan. A distribution of an offset amount is an eligible rollover distribution and subject to the mandatory 20 percent withholding to the extent that the 20 percent can be taken from the remaining assets in the distribution.

Example. Roger has a balance of \$5,000 in his employer's plan. \$1,500 is invested in a participant loan. Roger separates from service and requests that his entire balance be paid in a direct rollover to an IRA. The \$1,500 loan amount is offset against his \$5,000 balance in the plan. Thus, \$3,500 is paid in a direct rollover to his IRA. Roger will receive a Form 1099-R from his employer's plan indicating that \$5,000 was distributed using Code 1 or 7 depending on his age. The \$1,500 offset amount may be rolled over to the IRA if Roger makes up the difference from other sources. If Roger does not make up the \$1,500 difference as a rollover to the IRA, Roger will pay income taxes on the \$1,500.

Example. Assume the same facts in the preceding example, except that Roger does not elect a direct rollover to his IRA. Instead, Roger requests that the balance be paid directly to him. In this case, the mandatory 20 percent withholding would apply to the entire \$5,000, and Roger would receive only a \$2,500 distribution amount, computed as follows:

$$\$5,000 - \$1,500 \text{ loan offset} - \$1,000 \text{ withholding on entire amount} = \$2,500$$

If Roger did not want any portion of the distribution to be taxable, he could roll over a full \$5,000 into his IRA within 60 days. However, he would have to come up with the loan offset amount and the amount withheld for taxes (\$2,500.)

Interest-Only Distributions

The present regulations do not specifically address whether or not interest-only distributions from qualified plans are eligible rollover distributions and thus subject to the 20 percent withholding if they are not paid in a direct rollover to another plan.⁸⁴ Since interest-only distributions do not represent a series of payments over life or life expectancy, one could assume that interest-only payments would always be treated as eligible rollover distributions subject to the 20 percent withholding. On the other hand, it could be argued that interest-only distributions over a period of time which is expected to last for at least 10 years would not constitute eligible rollover distributions, and therefore, would be subject to the voluntary withholding rules.

Annuity Contract Distributed From Qualified Plan

A *qualified plan distributed annuity contract* is an annuity contract purchased for a participant and distributed to the participant by the qualified plan. Amounts paid under a qualified plan annuity contract are payments of the balance to the credit of the participant and are eligible rollover distributions, if they otherwise qualify.⁸⁵ For example, if the participant surrenders the contract for a single sum payment of its cash surrender value, the payment would be an eligible rollover distribution to the extent it is includible in income and not a RMD amount. This rule applies even if the qualified plan distributed annuity contract is distributed in connection with a plan termination. If any amount to be distributed under a qualified plan distributed annuity contract is an eligible rollover distribution, the annuity contract must satisfy the direct rollover option rules in the same manner as the qualified plan. The payor under the contract is treated as the plan administrator. If amounts are distributed from a qualified plan distributed annuity contract which are eligible

⁸⁴ Treas. Reg. Section 1.402(c)-2, Q&A 5.

⁸⁵ Treas. Reg. Section 1.402(c)-2, Q&A 10, 1.401(a)(31)-1, Q&A 16, and 31.3405(c)-1 Q&A 13.

rollover distributions, the payor under the contract must comply with the mandatory 20 percent withholding requirement in the same manner as the plan administrator would have had under the qualified plan.

Restrictions on Certain Terminated Defined Benefit Plans

When a defined benefit plan is terminated within 10 years of its inception, the IRS has required, in some determination letter requests, that the highest paid 25 employees could not receive a distribution until such time as all plan benefits were paid to the other employees and/or all liabilities under the plan were satisfied.⁸⁶

In certain cases, however, the IRS permitted such restricted employees to enter into some kind of escrow agreement or security agreement which allowed these employees to roll over their accrued benefit under the plan into an IRA. This escrow or security agreement also prevented any distribution from the IRA for a certain period of time. The only involvement of the IRA trustee and issuer under these types of agreements has been to recognize any withdrawal restrictions of the agreement and abide by its terms.

Rolling Traditional IRAs Into an Employer's Plan

Beginning in 2002, all distributions of taxable amounts from traditional IRAs, to the extent that the amount does not include RMD amounts and/or other ineligible amounts, are eligible for rollover into an employer's qualified plan, 403(b), or governmental 457(b).⁸⁷ Prior to 2002, only amounts originally distributed from a qualified plan or 403(b) account and maintained in a conduit IRA (not commingled with any other assets) could be rolled back to a qualified plan or 403(b) account.

The types of IRAs eligible for rollover to a qualified plan, 403(b) or 457 plan include traditional IRAs containing regular contributions, rollover (conduit) IRAs containing rollovers from qualified plans and 403(b) account, SEP IRAs and SIMPLE IRAs (after the participant has met the two-year holding requirement applicable to SIMPLE IRAs). Roth IRA assets cannot be rolled over to a qualified plan, 403(b), or 457(b) plan.

Practice Pointer: Qualified plans are not required to accept rollovers, including those from IRAs. Some that do accept rollovers limit the type of IRAs from which they accept rollovers. For instance a plan may be designed to accept rollover contributions from traditional, SEP and SIMPLE IRAs, or just from conduit IRA.

Maximum Amount Eligible to Be Rolled Over to an Employer's Plan

If the employer's plan accepts rollovers from IRAs, the maximum amount eligible to be rolled over from the above described IRAs is the amount that would otherwise be taxable to the individual, excluding RMDs and amounts otherwise not eligible for rollover treatment.⁸⁸ The taxable amount is determined by aggregating all of the types of IRAs listed above. Amounts that would not be considered taxable include nondeductible IRA contributions and after-tax employee contributions that have been rolled over to an IRA from a qualified plan or 403(b) account. The taxpayer is responsible for keeping track of any nontaxable basis amounts in his or her IRAs.

⁸⁶ Treas. Reg. Section 1.401(a)(4)-5(b), Rev. Ruling 92-76, Ltr. Rul. 9419040 (2/17/94).

⁸⁷ IRC Section 408(d)(3)(A)(ii).

⁸⁸ IRC Section 408(d)(3)(H).

Summary Charts

IRA Rollover Summary Chart

The following chart summarizes the rollover rules applicable to IRAs. It shows which types of IRA can be rolled over to other plans.

Employer Plan Rollover Summary Chart

The chart on the following page summarizes the rollover rules applicable to employer plans. It shows which types of employer plans can be rolled over to other plans.

Types of Plans

	Qualified Plan	403(b)	457(b)	Traditional IRA	SEP IRA	SIMPLE IRA	Roth IRA	Coverdell ESA
Qualified Plan	Yes, if plan accepts. If after-tax, must be direct rollover	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes. If after-tax, Form 8606 required by taxpayer	Yes. If after-tax, Form 8606 required by taxpayer	No	No	No
403(b)	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. If after-tax, must be direct rollover	Yes, if plan accepts. No rollover of after-tax allowed	Yes. If after-tax, Form 8606 required by taxpayer	Yes. If after-tax, Form 8606 required by taxpayer	No	No	No
457(b)	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes. If after-tax, Form 8606 required by taxpayer	Yes. If after-tax, Form 8606 required by taxpayer	No	No	No
Conduit IRA	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes, if plan accepts. No rollover of after-tax allowed	Yes, but there are benefits to keeping it separate	Yes, but there are benefits to keeping it separate	No	Yes, as a conversion	No

IRA Rollover Summary Chart

Types of IRAs	Rollover to Receiving Plans						Taxable Amount Only
	Traditional IRA	SEP IRA	SIMPLE IRA	Roth IRA	Coverdell ESA	Qualified Plan	
Traditional IRA (including Conduit IRA and SEP IRA)	Yes	Yes	No	Yes, as a conversion	No	Yes, only if qualified plan accepts.	Yes, only if 457(b) plan accepts
SIMPLE IRA	Yes, only after 2 years	Yes, only after 2 years	Yes	Yes, as a conversion after 2 years	No	Yes, only if QP accepts, only after 2 years	Yes, only if Gov't 457(b) accepts, only after 2 years
Roth IRA	No	No	No	Yes	No	No	No
Coverdell ESA	No	No	No	No	Yes	No	No

Note: Under the Pension Protection Act of 2006, effective for distributions that occur after December 31, 2007, direct conversions may occur from qualified plans, 457(b) and 403(b) plans to Roth IRAs. This does not affect the Roth conversion eligibility requirements (that is, the individual's modified AGI must be \$100,000 or less, and the tax filing status cannot be married filing separately).

Under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), signed into law on May 17, 2006, the \$100,000 MAGI limit and the requirement that married individuals file a joint tax return no longer applies (effective for tax years beginning January 1, 2010).

Chapter 17

State Taxation of Nonresidents

This chapter discusses the taxation of distributions from tax-favored retirement plans, nonqualified plans, and mirror plans under the Pension Source Act. For a number of years, the law concerning which states have a right to tax the qualified and nonqualified deferred compensation payments of current and former state residents has been unclear. The issue typically arises where an individual taxpayer spends some or all of his or her career in one state, earning both current and deferred compensation there, and retires to another state in which he or she receives the deferred compensation amounts. In some cases, both the state in which the taxpayer resides at the date of receipt of the deferred compensation and the state in which the taxpayer resided when the deferred compensation was earned (the source state) have attempted to tax the deferred compensation payments. In general, source states argued that the tax on the deferred income earned in their states was simply deferred by their states and not foregone entirely. In addition, they maintained that certain types of deferred compensation are not really retirement savings, but rather are simply deferred income intended to be used before retirement and therefore not entitled to be treated differently from the income from the same period that was paid when earned. The Pension Source Act provides a comprehensive federal statutory scheme to resolve the source tax dispute with respect to both tax-qualified and nonqualified plans.

Pension Source Act

The Pension Source Act¹ prohibits states (including political subdivisions of a state), the District of Columbia, and the possessions of the United States from imposing any income tax on the retirement income of an individual who is not a resident or domiciliary of the jurisdiction (as determined under the laws of that jurisdiction).² Making a nonresident pay tax on distributions of amounts deferred while he or she was a resident of a state is called *source taxation*.

¹ In 1995 Congress enacted the Pension Source Act which amended Title 4 of the United States Code to include new Section 114 to prohibit state taxation of certain retirement income of non-residents. See P.L. 104-95, 4 USC Section 114 (effective for payments received after December 31, 1995). This section provides that no state may impose income tax on any retirement income of an individual who is not a resident or domiciliary of such state. See 4 USC Section 114(a).

² 4 USC Section 110(d).

Note. The Pension Source Act does not prevent a state from denying deductions for contributions made to a retirement or deferred compensation plan or from including the amount contributed currently in the participant's income. Thus, with only the front door closed, states are still able to walk in the back door by not allowing business deductions or by limiting exclusions from the employee's income (or both). In addition, it remains to be seen how aggressive states will be in determining if an individual is domiciled within a state and then subjecting the unprotected benefits to taxation.

Income Tax

The term *income tax* is defined broadly as "any tax levied on, with respect to, or measured by, net income, gross income, or gross receipts."³

Note. Puerto Rico. A participant may be able to avoid federal and Puerto Rico taxation on his or her retirement plan benefits if (i) the participant is a United States citizen who resided for at least two years and rendered services exclusively in Puerto Rico; (ii) the plan is qualified in the United States and Puerto Rico and is funded through a Puerto Rico trust; (iii) the participant is a bona fide resident of the United States at the time of distribution; and (iv) the benefits are distributed through a lump-sum payment during the year of the change of residence to the United States, preferably after the individual has resided in the United States at least 180 days during the year.⁴

Note. Foreign plan or scheme. The general rule is that any income paid to a U.S. citizen or resident alien is subject to the federal tax laws of the United States. It should be remembered, however, that the federal tax law provides many exclusions, exceptions, and treaty offsets. Therefore, international pension distributions should be reviewed by a tax professional, experienced with international tax issues, before the distribution is made.

Domicile

Because the statute provides that domicile or residence is determined under the laws of the state seeking to tax the pension distributions,⁵ and not under the laws of the distributee's state of domicile or residence, it is possible for an individual's retirement income to be subject to state income tax in two or more states,⁶ and a state is not required to give credit for tax paid to any other state.

Protected Income

There is no dollar limit on the amount of retirement income that can be treated as retirement income. The Pension Source Act defines *retirement income* as any income from:

1. An eligible deferred compensation plan set up by a state or local government or tax-exempt organization pursuant to Internal Revenue Code (IRC or the Code) Section 457
2. A qualified retirement plan under IRC Section 401(a)
3. A qualified annuity plan under IRC Section 403(a)
4. A simplified employee pension plan (SEP) under IRC Section 408(k)

³ 4 USC Section 110(c).

⁴ Field Service Advice No. 200215019 (April 12, 2002); see also, Journal of Pension Benefits (JPAB), *Federal and Puerto Rico Taxation of Benefits From Puerto Rico Qualified Plans Received by United States Citizens*, Volume 10, Issue 2, Winter 2003, Aspen Publishers, New York.

⁵ 4 USC Section 114(a).

⁶ *Texas v. Florida*, 306 U. S. 398, 83 L. Ed. 817, 59 S. Ct. 563, 830, 121 ALR 1179.

5. A SIMPLE retirement account under IRC Section 408(p)
6. A tax-sheltered annuity plan under IRC Section 403(b)
7. An individual retirement account or annuity (IRA) under IRC Section 408
8. A government plan described in IRC Section 414(d) (These are plans set up by the United States government, a state or a political subdivision of a state, or any of their agencies or instrumentalities.)
9. A trust created before June 25, 1959, that is part of a plan funded only by employee contributions⁷
10. Certain retired or retainer pay of a member or former member of the uniformed services
11. A nonqualified plan, program, or arrangement subject to IRC Section 3121(v) (These are ineligible plans that benefit from special Social Security and unemployment tax rules, discussed later.)

The Pension Source Act protects “any income.” Thus, death benefits, disability benefits, and any other payments from a tax-favored plan to a nonresident are shielded from state taxation. Payments to nonresidents from an ineligible mirror plan (discussed later) may also be protected from source taxation.

Nonqualified Deferred Compensation Plans

Protection from source taxation may also be available on distributions from an ineligible plan, none of which are listed above. The term *retirement income* also includes income from a nonqualified deferred compensation plan, provided such income is one of the following:⁸

1. Part of a series of substantially equal periodic payments (not less frequently than annually) made for:
 - a. The life or life expectancy of the recipient (or the joint lives or life expectancies of the recipient and the recipient’s beneficiary), or
 - b. A period not less than ten years
2. A payment received after termination of employment from certain types of mirror plans (discussed later)

The definition of *periodic payments* under the Pension Source Act⁹ is nearly identical to that of *periodic payments* that are excludable from the definition of *eligible rollover distribution* with respect to a qualified plan, IRC Section 403(b) plan (403(b) plan), and eligible governmental IRC Section 457 plan (457 plan) distributions.¹⁰ Thus, for example, payments that could not be rolled over because of the periodic payment rules if they were made from a qualified plan will qualify for the pension source taxation. In addition, the following generally qualify as periodic payments:

- Disability benefits qualify, even though it is generally not known how long disability will last.¹¹
- Social Security supplements will not disqualify an otherwise qualifying periodic payment stream and will be considered to qualify.¹²

⁷ See IRC Section 501(c)(18).

⁸ 4 USC Section 114(b)(I).

⁹ 4 USC Section 114(b)(I)(i).

¹⁰ IRC Sections 402(c)(4)(A); Treas. Reg. Section 1.402(c)-2, Q&As-3, 5, and 6.

¹¹ Treas. Reg. Section 1.402(c)-2, Q&A-5.

¹² Treas. Reg. Section 1.402(c)-2, Q&A-5(b).

- Distributions made from an individual account plan until the account is exhausted will qualify if, based on reasonable actuarial assumptions, they may be expected to last at least 10 years.¹³
- In the case of a split distribution, such as an immediate lump-sum payment of \$20,000 with the balance payable in 10 annual installments, the installment payments qualify.¹⁴
- Certain one-time payments, such as a large initial retroactive check covering several months of benefits, or a “13th check” in the nature of a cost-of-living supplement, may be treated as part of the periodic payment stream.¹⁵

Nonqualified Plans

By definition, a *nonqualified plan* is “any plan, program, or arrangement described in Code Section 3121(v)(2)(C),” other than, in general, the various forms of tax-favored retirement plans described above. Under that section, special Social Security and unemployment tax rules generally provide that contributions are taken into account at the time the associated services were performed, or, if later, when no longer subject to a substantial risk of forfeiture. Gain is not taken into account under the special Social Security and unemployment tax rules.

Final Treasury regulations contain extensive guidance on the meaning of “plan of deferred compensation” for Federal Insurance Contributions Act (FICA) tax purposes.¹⁶ It appears that this guidance also will apply in determining when payments to nonresidents qualify for protection against state income taxes under the Pension Source Act.¹⁷

IRC Section 3121(v)(2)(C) defines *nonqualified deferred compensation plan* as any plan or other arrangement established and maintained by an employer that provides for the deferral of compensation. The final regulations impose additional requirements:

- *Written Plan Requirement.* A plan (including a plan that covers a single employee) is established as of the latest of (1) when it is adopted, (2) when it is effective, or (3) when its material terms are set forth in writing (or any other form approved by the Commissioner of Internal Revenue).¹⁸
- *Legally Binding Right.* A plan provides for the deferral of compensation only if the employee has a legally binding right during the year to compensation that has not been actually or constructively received and that is payable in a later year under the plan. Whether the arrangement is elective or nonelective is irrelevant. However, if an employer can unilaterally reduce or eliminate the benefit, other than by “operation of the objective terms of the plan” (for example, an offset to qualified plan benefits, forfeiture schedule), the plan does not provide for deferred compensation within the meaning of IRC Section 3121.

Note. Types of programs expressly excluded from the definition of a nonqualified plan under Code Section 3121(v) include stock option plans, SAR plans, excess golden parachute payments, executive severance plans, and window plans.

¹³ Treas. Reg. Section 1.402(c)-2, Q&A-5(d).

¹⁴ Treas. Reg. Section 1.402(c)-2, Q&A-6(a).

¹⁵ Treas. Reg. Section 1.402(c)-2, Q&A-6(b).

¹⁶ Treas. Reg. Section 1.3121(v)(2)-1(b).

¹⁷ Mazawey, “New Federal Limitations on State Taxation of Retirement Income,” *22 J of Pension Planning & Compliance* 2 (Summer 1996) 1.

¹⁸ Treas. Reg. Section 1.3121(v)(2)-1(b).

In general, the rules do not impose a minimum deferral period (beyond the next tax year) before payments will qualify for the special Social Security tax rules. Benefits paid for current services, and benefits established after services are performed, are both generally excluded from the definition.

Mirror Plans

A mirror plan is a nonqualified retirement plan maintained by an employer for providing benefits in excess of certain limits on contributions and benefits contained in the Code that apply to qualified retirement plans. The benefits provided under a mirror plan are those that would have been provided under the terms of a qualified retirement plan (including certain designated tax-sanctioned retirement plans) but for the application of the following limits on contributions and benefits:

- IRC Section 403(b) limits the amount of annual contributions that can be made to a tax-sheltered annuity (maintained by certain tax-exempt entities and public educational organizations). In addition to the IRC Section 415 limit on employer and employee contributions, which applies to tax-sheltered annuities, there is an annual dollar limit on elective contributions. For 2007, this limit is \$15,500, but it may be increased slightly (up to \$3,000 to a \$15,000 lifetime limit) if the employee has completed at least 15 years of service with a qualifying organization.
- IRC Section 415 limits the amount of annual contributions that can be made to a participant in a defined contribution plan and the benefits that can be provided to a participant under a defined benefit pension plan. The annual defined contribution limit is \$45,000 or 100 percent of compensation for 2007, plus catch-up contributions. For 2007, the maximum annual benefit that can be provided under a defined benefit plan is generally the lesser of 100 percent of the high three-years' average compensation (a limit that does not apply to governmental plans) or \$185,000, payable in the form of a straight life annuity with no ancillary features. Under that section, the participant's employer is considered to maintain the contract if the participant has more than 50 percent control of the employer.¹⁹ Thus, contributions to the tax-sheltered annuity program may have to be combined with all contributions made to qualified plans to determine whether the IRC Section 415 limitations have been exceeded.
- IRC Section 401(a)(17) limits the amount of annual compensation that can be taken into account under a qualified retirement plan for purposes of computing benefits and contributions to \$225,000 for 2007.
- IRC Section 401(k) limits the amount of elective deferrals (contributions at the election of the employee) that can be made by a highly compensated employee (HCE) to a qualified cash or deferred arrangement (commonly called a 401(k) plan) according to a nondiscrimination test based on the rate of such contributions (excluding catch-up contributions) made on behalf of nonhighly compensated employees (NHCEs).
- IRC Section 408(k) limits the amount of elective deferrals that can be made by a HCE to a salary-reduction or elective simplified employee pension plan (SARSEP) according to a nondiscrimination test based on the amount of such contributions made on behalf of NHCEs.
- IRC Section 401(m) limits the amounts of employer matching contributions and after-tax employee contributions that can be made to a 401(k) plan on behalf of HCEs according to a nondiscrimination test based on the amount of such contributions made on behalf of NHCEs.

¹⁹ Within the meaning IRC Section 414(b) or (c) (as modified by IRC Section 415(h)); see IRC Section 415(k)(4).

- IRC Section 402(g) limits the total annual amount of elective deferrals that can be made to a 401(k) plan (and similar arrangements) generally to \$15,500 for 2007, plus catch-up contributions if age 50 or older.

Maintained Solely for Providing Benefits in Excess of the Limitations

In the absence of regulations, determining when a plan is maintained solely for the purpose of providing retirement benefits in excess of the limitations discussed above or any other limitation on contribution or benefits ("excess benefit plan") under the Code on plans to which such sections apply may be difficult to ascertain. Fortunately, the periodic payment rule (discussed above) assumes that these amounts are not subjected to state income tax upon distribution. Commentators have suggested that employers may have to split their nonqualified plans into two or more arrangements to get the protection and benefit offered by the Pension Source Act.²⁰

Arguably, a plan that contains a nonprotected benefit would not qualify under the maintained solely rule. As a consequence, distributions from such a plan could be subject to state source taxation. It also remains to be seen how aggressive states will be in determining when an individual is domiciled within a state and in subjecting unprotected benefits to taxation.

If an employer wants to design a nonqualified plan that enjoys the protection afforded by the excess benefits provision (as opposed to the protection afforded by the periodic payments provision of the Pension Source Act, the employer will need to be careful to ensure that the plan is maintained solely for the purpose of providing retirement benefits in excess of the various Code limitations applicable to qualified plans. In other words, if an employer wants to provide such excess benefits, as well as nonqualified benefits not related in any way to the Code's qualified plan limits, it should consider providing those two types of nonqualified plan benefits in two separate plans to achieve source tax law protection for the excess benefit plan that would not be available were the plan not maintained solely for the purpose of providing the excess benefits.²¹

Note. The definition of excess benefits in the Pension Source Act is much broader than the definition of excess benefit plan in ERISA Section 3(36).²² Specifically, the definition in ERISA Section 3(36) includes only those plans designed to provide benefits in excess of the limits of Code Section 415: the Pension Source Act definition of excess benefits includes benefits in excess of (i) the Code Section 401(a)(17) compensation limit (\$225,000, as indexed for 2007, and indexed in \$5,000 increments thereafter), (ii) the Code Section 414(s) limitations on the forms of compensation that may be taken into account by qualified plans, (iii) the average deferral percentage (ADP) and average contribution percentage (ACP) test limits applicable to 401(k) plans, (iv) the salary reduction dollar limits for 401(k) and 403(b) plans, (v) the maximum exclusion allowance limit for 403(b) plans, (vi) the Code Section 415 limits, (vii) and "any other limitation" on contributions or benefits applicable to qualified plans.²³

Employers sponsoring nonqualified plans should review those plans carefully to determine whether the plans enjoy protection under the Pension Source Act and should modify their state tax withholding procedures accordingly. This is especially important for employers with nonqualified plans that are not so

²⁰ Lesser, "State Taxation of Pension Income Curtailed," 4 *J of Taxation of Employee Benefits* 2 (July/Aug 1996) 88; Mazaway, "New Federal Limitations on State Taxation of Retirement Income," 22 *J of Pension Planning & Compliance* 2 (Summer 1996) 1.

²¹ Smith and Connors, *Nonqualified Deferred Compensation Answer Book* (6th Ed.), Q 1:19, Aspen Publishers, New York (2007).

²² *Id.* See Chapter 3.

²³ Arguably, the broad "any other limitation" language of the law could be interpreted to include plans designed to provide benefits not permitted in a qualified plan because of the general nondiscrimination rules of Code Section 401(a)(4) or the minimum coverage rules of Code Section 410(b), although the point is not clear from the statute.

protected and that maintain operations in more than one state. The clarity provided by the Pension Source Act may actually encourage some states to become more aggressive with respect to collecting source state taxes on unprotected nonqualified plan benefit payments.

Termination From Service

In-service payments under a window plan are not protected from source taxation. Only payments after termination of service from a plan that is maintained solely for the purpose of providing benefits in excess of limitations on contributions or benefits in the Code are protected by the Pension Source Act.

Chapter 18

Creditor Protection

Although a plan under the Employee Retirement Security Act of 1974, as amended (ERISA) is protected from creditors under state and federal law, The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPA) adds another level of protection, especially for those plans that are not protected under ERISA. BAPA makes significant changes to the protection afforded to a debtor's interest in pension plans, benefits plans, and retirement accounts. In general, BAPA excludes from the bankruptcy estate retirement funds to the extent that those funds are in a fund or account that is exempt from taxation.

Protection Under ERISA

Under Section 3 of ERISA, the only employee benefit plans subject to Title I of ERISA (regarding the protection of employee benefit rights) are those within the meaning of ERISA Section 3(3), provided such a plan is established or maintained by an employer engaged in commerce or in any industry or activity affecting commerce, by an employee organization or organization representing employees engaged in commerce or in any activity affecting commerce, or by both. Section 3(2) of Title I of ERISA defines the term *employee pension benefit plan* as follows:

[A]ny plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program

- i. provides retirement income to employees, or
- ii. results in a deferral of income by employees for periods extending to the termination of covered employment or beyond,

regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.¹

It should also be noted that an asset that is held in trust and subject to an enforceable nonbankruptcy restriction on transfer (a “spendthrift clause”) is generally not part of the debtor’s bankruptcy estate.²

¹ See also *LaChapell*, 901 F. Supp. at 24 n. 1; 45 Fed. Reg. 24866, 24867.

² 11 USC Section 541(c)(2); ERISA Section 206(d)(1); 11 USC Section 1056(d)(1).

In 1992, the Supreme Court ruled that an ERISA-required “antialienation” clause in a qualified pension plan is an enforceable nonbankruptcy law restriction on transfers within the meaning of 11 United States Code Section 541(c)(2).³ Simplified Employee Pension Plan (SEP) and Savings Incentive Matching Plan (SIMPLE) IRA plans are not subject to the “antialienation rules” and are not generally treated as ERISA plans for *bankruptcy* purposes; many exclusions and exceptions apply for other purposes under ERISA.⁴ The new bankruptcy rules (discussed later) provide protection for IRS qualified plans. Not all IRS qualified retirement plans are ERISA covered plans. ERISA’s antialienation clause applies only to “employee benefit plans.”⁵

ERISA Covered Plans

Under Department of Labor regulations, for purposes of determining whether a plan is an “employee benefit plan” covered by Title I of ERISA, an individual and his or her spouse are not deemed to be “employees” with respect to any business wholly owned by either or both of them, and a partner and his or her spouse are not “employees” with respect to the partnership.⁶ Therefore, unless the plan covers one or more employees (other than the business owner, partners, and/or their spouses), the plan is not an employee benefit plan that is subject to ERISA’s antialienation clause (although it may be an IRS qualified plan for tax purposes).⁷ In such a case (for a plan without employees), the only exemption for a nonERISA “qualified plan” is found in Bankruptcy Code Section 522 (see the following text). Although a qualified plan is exempt in bankruptcy, the *Paterson* decision may still be useful when an ERISA covered plan is not (or not treated as) a qualified plan, and state exemptions do not apply or are unavailable. To be an ERISA plan, the plan must cover at least one or more employees. If a plan also covers one or more employees (in addition to the business owner, partners, and/or their spouses), then it is an employee benefit plan under Title I of ERISA, and the sole business owner, partners, and/or their spouses are treated as “employees” and “plan participants” for ERISA Title I purposes.⁸ A plan treated as an ERISA Title I plan is also exempt from creditors in the event of bankruptcy.

Caution: *On April 4, 2005, the Supreme Court unanimously ruled in Rousey v. Jackoway that IRA assets are protected from bankruptcy under Bankruptcy Code Section 522(e)(10)(E) to the extent that it “is reasonably necessary to support the account holder or his dependents.” However, Rousey was an interpretation of pre-BAPA rules. In light of the express provisions regarding IRAs (and other “retirement funds”) in the BAPA, the court’s holding in Rousey may no longer be applicable.*

Bankruptcy Law Protection

In general, the debtor’s bankruptcy estate includes, among other things, “all legal or equitable interests of the debtor in property.”⁹ Once an item is included in the bankruptcy estate, an exemption may apply to exclude the item. Obviously, if an item is not considered part of the debtor’s estate in the first place (for example,

³ See also *LaChapell*, 901 F. Supp. at 24 n. 1; 45 Fed. Reg. 24866, 24867.

⁴ USC Section 1002(2), see also, DOL Reg. Sections 2510-3-2(d), 2520-104-4 and -49 presuming the applicability of ERISA to a SEP.

⁵ See ERISA Section 3(3); 29 USC Section 1056(d)(1).

⁶ DOL Reg. Section 2510.3-1.

⁷ See *Yates v. Hendon*, 541 U.S. 1 (2004).

⁸ *Id.*

⁹ 11 USC Sections 541(a), 541(a)(1).

spendthrift trust), it certainly will not be treated as part of the bankruptcy estate.¹⁰ State and local law, when applicable, may also provide for additional exemptions (see below).

Property Exempt in Bankruptcy

Exactly what property is protected in bankruptcy depends on the exemption scheme chosen.

Two exemption schemes are used. Bankruptcy Code Section 522(b)(1) provides that a debtor may exempt from property of the bankruptcy estate, the property specified in Bankruptcy Code Section 522(b)(2), which is called the “federal law only” scheme, or Section 522(b)(3), which is called the “federal plus state law” scheme. Residency requirements determine which state’s exemptions may be used, when applicable.¹¹ If the petitioner is not properly domiciled (for federal bankruptcy purposes) in a state to be entitled to use that state’s exemptions, the individual must use the “federal law only” scheme (that is, 11 USC Section 522(b)(3)). On the other hand, if the petitioner is properly domiciled (for federal bankruptcy purposes) in a state that requires the petitioner to use the “federal plus state law” scheme, the individual must do so. Otherwise, the debtor may choose one of the two schemes.

The exemptions for Bankruptcy Code Section 522(b)(2) (the federal law only scheme) are listed in Section 522(d). The Section 522(d) and 522(b)(3) exemption lists are different; however, both lists include the following:¹²

[R]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.

Regardless of which scheme is chosen, many types of retirement funds are protected in bankruptcy. For assets in an IRA or Roth IRA, other than those assets attributable to a SEP or a SIMPLE IRA, the aggregate value of such assets exempted shall not exceed \$1 million in a case filed by a debtor who is an individual, except that such amount may be increased if the interests of justice so require.¹³ The \$1 million cap does not apply to amounts attributable to rollover contributions under Code Sections 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8).¹⁴ An unlimited exemption applies to amounts attributable to contributions made by an employer (including elective contributions) to a SEP IRA or SIMPLE IRA.¹⁵

Note. BAPA changes (S. 246) to the Bankruptcy Code are generally effective only with respect to cases filed after its effective date, October 17, 2005 (180 days after the date of enactment of BAPA, April 20, 2005).¹⁶ Special residency tests may apply in determining applicable state law.¹⁷

Note. For retirement plan asset protection under the bankruptcy rules before BAPA, the case would have to be filed on or before October 17, 2005, however, the limitations on the homestead exemptions are effective April 17, 2005.

¹⁰ 11 USC Section 541(c)(2).

¹¹ 11 USC Section 522(b)(3)(A).

¹² See 11 USC Section 522(b)(3)(C) (if federal plus state law scheme) and Section 522(d)(12) (if federal law only scheme).

¹³ 11 USC Section 522(n).

¹⁴ 11 USC Sections 522(b)(1), 522(b)(2), 522(b)(3), 522(d), 522(e)(10).

¹⁵ 11 USC Sections 522(b)(1), 522(b)(3)(C), 522(d) (referenced by §522(b)(2)).

¹⁶ BAPA Section 1501 (S. 246).

¹⁷ 11 USC §522(b)(3)(A).

Bankruptcy Protection for Retirement Plan Assets

Although an ERISA plan is protected from creditors under state and federal law, the PABA adds another level of protection, especially for those plans that are not protected under ERISA. Sweeping bankruptcy reforms were passed by the Senate as BAPA, passed by the House without modification, and signed by President Bush on April 20, 2005.¹⁸ The BAPA makes significant changes to the protection afforded to a debtor's interest in pension plans, benefits plans, and retirement accounts. In general, BAPA excludes from the bankruptcy estate retirement funds to the extent that those funds are in a fund or account that is exempt from tax, as follows:

- A traditional IRA and/or Roth IRA (other than SEP IRA or SIMPLE IRA), up to \$1 million in the aggregate, except that such amount may be increased if the interests of justice so require.
- A SEP IRA or SIMPLE IRA, unlimited exemption. However, a \$1 million cap applies, in the aggregate, to annual amounts attributable to traditional IRA contributions (that is, including earnings) that may be in a SEP IRA or SIMPLE IRA.
- A plan under Code Section 414 (governmental plans, church plans, multiemployer plans).
- A plan under Code Section 457 (eligible Section 403(b) plans, ineligible 457(f) plans).
- A plan under Code Section 403 (qualified annuity plan, Section 403(b) annuity plans, Section 403(b)(7) mutual fund custodial accounts, and Section 403(b)(9) retirement income church accounts).
- A debtor's interest in retirement funds that are exempt from tax under Code Section 501(a).
- A direct rollover or distribution that is rolled over within the requisite 60-day period from a plan listed above to another such eligible plan.
- Distributions from the plans listed previously that are rolled over within the requisite 60-day period from one plan listed previously to another such eligible plan. Thus, the rollover may be completed after the bankruptcy petition is filed (but within 60 days).¹⁹ In addition, an employee benefit plan subject to Title I of ERISA is protected in bankruptcy.²⁰ Most, but not all qualified plans, are subject to Title I of ERISA.

Note. The House legislative history accompanying S. 256 (BAPA) states that the “intent of section 224 is to expand the protections for tax-favored retirement plans or arrangements that may not be already protected under Bankruptcy Code Section 541(c)(2). . .” [regarding property of the estate] “. . . pursuant to *Patterson v. Schumate*, 504 U.S. 753 (1992).”²¹ Senator Orrin Hatch (R-UT) provided similar explanatory language when the Senate passed the bill on March 10, 2005. No conference committee was necessary because the House and Senate-passed bills were identical.²²

Note. The \$1 million cap applicable to traditional IRAs (other than funds attributable to SEP IRA or a SIMPLE IRA contribution) may be raised, presumably on a case-by-case basis, “if the interests of justice so require.”²³ Although the economic value of a Roth IRA (which generally allows for tax-free distributions) is worth more than a traditional IRA (where distributions are generally taxable, except to the extent that nondeductible contributions are distributed), the new bankruptcy rules make no distinction. Thus, all

¹⁸ Pub. L. No. 109-8.

¹⁹ 11 USC Sections 522(b)(4)(D)(i), 522(b)(4)(D)(ii).

²⁰ *Patterson v. Schumate*, 504 U.S. 753 (1992).

²¹ House Rep. No. 109-31.

²² 11 USC Sections 522(b)(1), 522(b)(2), 522(b)(3), 522(n); see also, 11 USC Section 522(d)(E)(10).

²³ 11 USC Section 522(n).

traditional IRAs (other than funds attributable to SEP IRA or SIMPLE IRA contributions) and Roth IRAs are aggregated and generally subject to the \$1 million cap.

Note. Because IRAs are created and funded by the owner and the assets can be withdrawn, an IRA will not qualify as a spendthrift trust under state law, even if the IRA agreement has an anti-alienation clause.²⁴

“Once a debtor goes into bankruptcy, they become subject to the bankruptcy law exemption limitations.”²⁵ Thus, under BAPA, the following are likely results for traditional IRA funds under both bankruptcy schemes:

1. *Failing to coordinate a beneficiary designation’s provisions with those made in other nonprobate designations, trusts, and a will.* Although a beneficiary designation’s provisions need not be the same as those of a participant’s will or other dispositions, if they are different the maker should understand why he or she has made different provisions and whether they are likely to add up to a combined result that he or she wants.
2. If the federal law only scheme is used under Bankruptcy Code Section 522(b)(2) and the state-law traditional IRA exemption is:
 - a. \$100,000. The exemption amount is increased to \$1 million.²⁶ The state exemption is trumped.
 - b. \$1 million. \$1 million is used.
 - c. \$2 million. The state exemption amount is *capped* at \$1 million.²⁷
3. If the federal plus state law exemption scheme is used (for example, in an opt-out state) under Bankruptcy Code Section 522(b)(3) and the state-law traditional IRA exemption is:
 - a. \$100,000. The exemption amount is increased to \$1 million.²⁸
 - b. \$1 million. \$1 million is used.
 - c. \$2 million. The state exemption amount is capped at \$1 million.²⁹

Practice Pointer: A taxpayer should consider segregating their voluntary contribution IRAs from rollover arrangements so that accounting and calculation to determine what is protected and what is not protected in future years will not be an expensive or uncertain process.³⁰

Caution: *It would appear that amounts attributable to an inherited IRA that originated from a qualifying rollover distribution from a “qualified plan” are not subject to the \$1 million cap.*³¹

Creditor Protection Under State Law

SEP assets may be subject to the claims of creditors or the IRS in a nonbankruptcy situation. Nearly all states grant creditor protection for assets held in an IRA, including a SEP IRA. Most states, however, do not offer any protection from creditors for assets held in an IRA that is established and maintained by a

²⁴ 11 USC Section 541(c)(2); see also *In re CRS Stream*, 217 Bankr. 365 (Bankr. Mass. 1998).

²⁵ Letter to editor, Alan S. Gassman, Esq., Gassman, Bates, & Associates, P.A., Clearwater, FL (Aug. 13, 2007).

²⁶ 11 USC Section 522(d)(12).

²⁷ 11 USC Section 522(n).

²⁸ 11 USC Section 522(b)(3)(C).

²⁹ 11 USC Section 522(n).

³⁰ Letter to editor, Alan S. Gassman, Esq., Gassman, Bates, & Associates, P.A., Clearwater, FL (Aug. 13, 2007).

³¹ 11 USC Section 522(n).

participating employee for the holding of SEP contributions. Recently, the Sixth Circuit affirmed a district court order holding that an attorney's SEP was subject to garnishment to satisfy a judgment for violating ERISA.³² The status of assets held in an employer (or "group") IRA under Code Section 408(c) has not been determined, but, in the authors' opinion, a participant's interest should be treated no differently from a regular, "self-settled" IRA.

Note. The IRS can enforce a federal lien against an IRA.³³ Amounts distributed from an IRA, even if used to satisfy a federal lien, are generally (but not always) subject to the premature distribution penalty if the IRA owner is under age 59½.³⁴

Chapter Examples

The following examples assume the bankruptcy provisions of BAPA are in effect.

Example. Jerome has a SEP IRA. His employer SEP contributions (including elective contributions if a SARSEP) aggregated \$3 million (with earnings). He rolled over \$1.5 million from a qualified plan that is now worth \$2 million. Jerome also made annual contributions into his IRA that are now worth \$500,000. Jerome's entire IRA is protected from creditors. Amounts in the IRA attributable to the SEP contributions and the rollover contributions from the qualified plan have an unlimited exemption. The portion representing annual contributions to the traditional IRA are also exempt because they do not exceed the \$1 million exemption limit amount.

Example. Same facts as in Example 1, except that the portion of Jerome's SEP IRA attributable to annual traditional contributions is worth \$4 million. Jerome's bankruptcy estate will include \$3 million of the \$4 million because only the first \$1 million is covered by the exemption (unless the interests of justice require a larger amount to be exempt).

Example. Same facts as in Example 2, except Jerome is responsible for supporting a wife and seven children; he is also disabled and has limited resources outside of his bankruptcy estate. If the "interests of justice so require," the bankruptcy trustee could exempt more than the \$1 million attributable to annual traditional IRA contributions.

Note. Under the bankruptcy law (as changed by BAPA), a state's homestead exemption will only protect the debtor's interest in excess of \$125,000 (if allowed by local state law) if the interest was acquired at least 1,215 days (3 years and 4 months) before the filing of the bankruptcy petition. Interests in excess of \$125,000 that are acquired within the 1,215-day period are not protected. Thus, a debtor no longer can pay down a home mortgage immediately before bankruptcy and expect the new home equity to be exempted from the bankruptcy estate if the equity in the homestead exceeds \$125,000.

Example. Peyton lives in a state with an unlimited homestead exemption but no exemption for retirement assets. His home is worth \$7 million. He has a traditional IRA and a Roth IRA worth \$800,000. None of the funds in the traditional IRA consist of assets that were rolled over from a protected plan or are

³² *Lampkins v. Golden*, 28 Fed. App. LEXIS 409, 2002 WL 74449 (6th Cir. Jan. 17, 2002).

³³ IRC Section 6334.

³⁴ Chief Counsel Notice N(36)000-2 (Jan. 21, 2000).

attributable to SEP IRA or SIMPLE IRA contributions. If Peyton does not file for bankruptcy, his IRA and Roth IRA funds may not be protected, but if he does file for bankruptcy, then his homestead may be limited to \$125,000.

Example. Same facts as in Example 4, except Peyton's Roth IRA and traditional IRA are worth \$2 million. Only \$1 million of the IRA assets will be protected in bankruptcy (unless the interests of justice require a greater amount to be exempt).

Example. Same facts as in Example 4, except Peyton is domiciled (for federal bankruptcy purposes) in an opt-out state that requires him to use the "federal plus state-law exemptions." Peyton's IRA is not treated as an ERISA plan, therefore, the IRA will only be exempt to the extent provided by Bankruptcy Code Section 522(b)(3) and other Federal, state, and local law. Although the state does not provide for an exemption, Section 522(b)(3) excludes the IRA.³⁵ Thus, \$1 million is exempt property and cannot be reached in bankruptcy. The result would be the same if state or local law exempted less than \$1 million (say \$250,000) or more (say \$2 million). Because Peyton is precluded from using the "federal law only" scheme, he may not use the exemptions found in Bankruptcy Code Section 522(d); the exemptions found in Section 522(b)(A)–(D) are applicable (which include federal nonbankruptcy law and applicable state and local laws).³⁶

Note. Asset protection plans were also attacked by BAPA by giving bankruptcy trustees broad powers to avoid transfers made to such trusts.³⁷ Before BAPA, a debtor could threaten to file a bankruptcy petition to wipe out creditors' claims. Now, creditors may threaten to force a debtor into bankruptcy so that the debtor's assets can be reached.

³⁵ 11 USC Section 522(b)(3)(D).

³⁶ 11 USC Section 522(b)(3)(A).

³⁷ 11 USC Sections 548, 548(a), 548(b).

Chapter 19

Entity Choice—To Be or Not to Be

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The choice of entity decision is one of the most important decisions facing owners of small businesses. There are several forms to choose from, and each has different legal and tax consequences. No one form of entity is appropriate for every kind of business. Making this assessment requires an understanding of not only the major tax and nontax aspects of each form of business, but also how the comparative advantages and disadvantages of each relate to the needs of a specific client. The limited liability company (LLC) has become a popular entity choice because it offers the limited liability of a corporation with the single level of tax of a partnership. Members of an LLC can be taxed either as general partners, subject to self-employment tax, or as limited partners, exempt from self-employment tax, depending upon their level of participation in the business.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA or the Act) retroactively reduced the individual marginal tax rates for the tax year 2003 to 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent, set the 15 percent bracket for joint filers and the basic standard deduction to twice the single filer amounts. In addition, the Act reduced the tax rate on capital gains to 15 percent for taxpayers in the 25 percent or higher tax bracket and to only 5 percent for taxpayers in the 10 percent and 15 percent brackets. The Act did not make any changes to the corporate tax rate structure. The Act thus increased the preference for operating a business as a pass-through entity rather than as a regular C corporation. The Tax Increase Prevention and Reconciliation Act of 2005 extended the reduced marginal income tax rates and the 15 percent capital gains rate through December 31, 2010 and reduced the 5 percent rate for taxpayers in the lowest brackets to 0 percent for tax years beginning after December 31, 2007 and before January 1, 2011.

Comparison of Entities¹

In many cases, there are tax benefits to operating a business as a flow-through entity, such as an LLC or an S corporation. If the business generates losses, deduction of losses by partners, LLC members, or shareholders is usually preferable to those losses offsetting only future corporate income. If the business generates profits, the direct taxation of partners or shareholders is usually preferable to the double taxation that is the norm for C corporations (that is, taxation of the entity followed by taxation of shareholders if earnings are distributed). If the double tax can be mitigated, such as by paying out earnings as reasonable rent or salary, the use of a C corporation may be preferable.

The major disadvantage of an S corporation is its lack of flexibility. The number and type of shareholders are severely restricted, and it may have only one class of stock. Special allocations of items of income or loss to particular shareholders are not permitted. In addition, because of the rules for determining basis, an S corporation shareholder may be unable to deduct losses and is more likely to recognize gain from the distribution of property than a partner or a member of an LLC.

A major disadvantage of a general partnership is that partners are jointly liable for the debt of the partnership. This is not always a problem since personal liability may be mitigated by insurance or other means. If the liability of partners for the debts of the partnership is a problem, a limited partnership may be the solution, provided the limited partners restrict their participation in the management of the partnership or risk the loss of their limited liability. An LLC may offer the best of both worlds, namely, limited liability for all members in addition to taxation as a partnership.

Nontax Factors

Formalities of Existence

Of the major forms of business, C and S corporations have the most burdensome requirements regarding the formalities of existence. A corporation is a separate legal entity from its owners and must file articles of incorporation with the secretary of the state in the jurisdiction of organization. Accordingly, it must also adopt bylaws, elect a board of directors, hold organizational meetings, and keep minutes thereof. In addition, each state has its own incorporation requirements that must be examined and observed. A general partnership usually has no formal registration requirements and may be established informally without a written agreement. A limited partnership, as a creature of state statute, must observe certain formalities. In particular, a certificate of limited partnership must be filed with the secretary of the state of formation. The LLC must similarly follow the organizational requirements imposed by state law.

Limited Liability of Owners

In general, the owners of a C or an S corporation are not personally liable for the entity's obligations. However, an owner who guarantees a debt or commits a tort while acting on behalf of the entity may lose this protection. Limited liability may be lost if the entity either is undercapitalized or fails to maintain a separate identity from its owners. Since LLCs are state-created entities, there is little uniformity from state to state with respect to the extent of the limited liability of its members. Unlike a corporation or a LLC, a general partnership does not afford its owners limited personal liability. Its partners are personally liable for partnership

¹ Acknowledgment: Portions of this article appeared in "Entity Choice after the Jobs and Growth Tax Relief Reconciliation Act of 2003," published in *TAXPRO Quarterly Journal* (Summer 2003) 17–23. Reprinted with permission.

debts and for the acts of fellow partners performed in furtherance of partnership business. General partners in a limited partnership have the same type of personal liability, as do their counterparts in a general partnership. The liability of limited partners who do not participate in the management of the business is limited to the extent of their investment.

Ability to Raise Capital

The regular corporation has the greatest ability to raise capital because, unlike the S corporation, there are no limits on the number or types of shareholders it may have. Also, a regular corporation has the ability to issue different kinds of stock, such as preferred stock, to attract new investors, while S corporations are prohibited from having more than one class of stock. Partnerships and LLCs may find it extremely difficult and time-consuming to amend the partnership agreement in order to raise additional capital by admitting new partners or members.

Participation in Management

In a regular corporation, the management of the business does not necessarily rest with the owners. Shareholder interests are protected by a board of directors, which makes broad policy decisions while leaving the day-to-day operation of the business up to management. Since the number of S shareholders is limited, it may be possible for a few shareholders to exercise control over the business. In a partnership or a LLC, the general partners act as both owners and managers and have significant input in how the business is run. Limited partners, on the other hand, act only to protect their investment interests and forgo any involvement in the operations of the business. If the investor is comfortable with a passive role, then a regular corporation or a limited partnership is preferable. An owner desiring a more active role in management should choose an S corporation or a general partnership.

Transferability of Interests

The free transferability of interests is the major advantage of a corporation. If stock is publicly traded, ownership interests can be bought and sold with ease. For companies with stock that is not publicly traded, private placements are still possible. Unless the corporation is a professional service corporation, there is usually no restriction on who can own stock, making it possible to transfer ownership interests to relatives and business associates. Usually, the transfer of a partnership interest is more complex, since restrictions on transfers may be included in the partnership agreement. Also, it is much easier to transfer a portion of an ownership interest in a corporation which is stated in the number of shares owned. Dividing up a partnership interest is a more complex process, since the partnership agreement would have to be amended to reflect the new ownership interest of each partner.

Tax Factors

Tax Aspects Upon Formation

If either a C or an S corporation is formed, the owners generally contribute property or services to the entity in exchange for stock. If property is contributed, the owners do not recognize gain on receipt of the stock provided they are in control of the corporation, defined as owning 80 percent or more of the voting power and 80 percent or more of all other classes of stock. If the contributors receive something other than stock, (that is, cash/boot), gain is recognized to the extent of the nonqualifying property received. This rule also applies if the individual contributes property subject to debt, (the transferor is treated as having received cash equal to the

amount of the debt). An individual who contributes services in exchange for stock must generally recognize gain. However, the corporation may be able to deduct the compensation to the extent it is not treated as a capital expenditure.

As most practitioners know, the tax consequences of forming a partnership or a LLC are similar to those governing corporate formation. A contribution of property to the entity in exchange for an ownership interest is generally not a taxable event. In addition, the partnership nonrecognition rules are more liberal than the corporate rules since there is no requirement that the owners be in control of the partnership after the contribution. If a partner contributes encumbered property to a partnership, the other owners' share of the liability is deemed to be distributed to the contributing owner. Debt relief in excess of the basis of contributed property is recognized as gain by the contributing partner. A partner who contributes services in exchange for a partnership interest generally recognizes gain equal to the value of the interest received. Similar to the corporation, a partnership may be able to deduct the compensation to the extent it is not treated as a capital expenditure.

Contribution of Property Examples

Example. A increased her stock ownership in the ABC Corporation to 40 percent by transferring land with a fair market value (FMV) of \$10,000 and a basis of \$4,000. She recognizes gain of \$6,000 on the transfer because, after the transfer, she does not meet the 80 percent control test. Her basis in the shares of stock issued for the land is \$10,000.

Example. A was admitted as a partner in the ABC partnership. She acquired a 20 percent interest by contributing property with a FMV of \$10,000, an adjusted basis to A of \$4,000, subject to a mortgage of \$2,000. The mortgage was assumed by the partnership. The basis of A's interest in the partnership is \$2,400, computed as follows:

Adjusted basis to A of property contributed	\$4,000
Less portion of mortgage assumed by other partners, which must be treated as a distribution (80 percent of \$2,000).	(1,600)
Basis of A's interest	\$2,400

Example. If the property contributed by A were subject to a mortgage of \$6,000, A would recognize a gain of \$800 and her basis in the partnership interest would be zero, computed as follows:

Adjusted basis to A of property contributed	\$ 4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of \$6,000)	(4,800)
	\$ (800)
Recognized gain	\$ 800
Basis of A's interest	\$ 0

Since A's basis cannot be less than zero the \$800 in excess of basis is considered as a distribution of money under Internal Revenue Code (IRC or the Code) Section 752(b) and is treated as capital gain from the sale or exchange of a partnership interest, which increases her basis to \$0.

Example. A acquired a 20 percent interest in an S corporation by contributing property. At the time of A's contribution, the property had a FMV of \$10,000, an adjusted basis to A of \$4,000, and was subject to a mortgage of \$2,000. The corporation assumed the mortgage. The basis of A's stock is \$2,000, computed as follows:

Adjusted basis to A of property contributed	\$4,000
Less mortgage assumed corporation	(2,000)
Basis of A's interest	\$2,000

Example. If the property contributed by A were subject to a mortgage of \$6,000, A must recognize a gain of \$2,000, and her basis in the stock would be zero, computed as follows:

Adjusted basis to A of property contributed	\$4,000
Less portion of mortgage assumed by corporation	(6,000)
	-2,000
Recognized gain	\$2,000
Basis of A's interest	\$ 0

Tax Aspects Upon Sale

The tax preference for qualified small business stock (QSBS) issued after August 11, 1993, and held by the taxpayer for five years, was repealed by the 2003 Act. After May 5, 2003, these gains are eligible for the 15 percent capital gains tax rates.

Loss on the sale (or worthlessness) of stock usually results in a capital gain or loss subject to a \$3,000 per year deduction for capital losses in excess of capital gains. Loss on the sale of an unincorporated business, such as a sole proprietorship, reflects the sale of the underlying business assets and may be eligible for ordinary loss treatment under IRC Section 1231.

IRC Section 1244 provides similar ordinary loss treatment for shareholders in certain small business corporations in which the equity capital at the time of stock issuance does not exceed \$1 million. IRC Section 1244 stock ownership offers more favorable tax results than debt should the enterprise fail. The maximum loss allowed each year is \$100,000 if married filing joint, or \$50,000 if single. If the IRC Section 1244 stock loss exceeds the individual's taxable income for the year, the excess is allowable in computing a net operating loss under IRC Section 172, which can be carried back or carried forward.

Taxation as a Separate Entity Versus a Pass-Through Entity

One of the main factors affecting the choice of entity is whether its items of income, credit, loss, and deduction should pass through and be reported by the owners on their personal tax returns. One disadvantage of a C corporation is that its earnings are taxed twice—once when earned at the corporate level and again when

distributed to shareholders. This double taxation may be minimized in the context of a closely held corporation if the entity pays out most or all of its earnings as (deductible) salary (the amount must be reasonable) or rent. S corporations and partnerships provide pass-through treatment. In general, there is no entity-level tax so the earnings are taxed once at the owners' marginal rates. Unlike S corporations, partnerships permit special allocations of tax attributes provided such allocations have substantial economic effect. Such allocations can often help a business raise equity capital from outside investors while enabling the general partners to maintain control of the business. Pass-through entities are often good choices for businesses expected to generate losses in the early years because the active owners ordinarily can deduct those losses against income from other sources.

Taxation of Owner Compensation

An owner of a C corporation can be compensated through salary, fringe benefits, pension and profit-sharing plans, and dividends. Of these types of compensation, dividends are usually the least preferred because they are subject to tax at both the entity and shareholder levels. Salaries, to the extent they are reasonable in amount, are effectively taxed only once (as income to the owner) because they are deductible by the entity. In addition, they are subject to FICA taxes.

The net income attributable to the owners of a flow-through entity is subject to the following different self-employment tax rules:

- A sole proprietor's net income from self-employment whether distributed or not is subject to self-employment tax.
- Wages paid by an S corporation are subject to Federal Insurance Contributions Act (FICA) tax, but an S corporation shareholder's distributive share of income is excluded from self-employment income.
- A general partner's distributive share of trade or business income is includible in self-employment income, as are guaranteed payments.
- A limited partner's distributive share of trade or business income is excluded from self-employment income.
- An LLC member's distributive share of trade or business income is included in self-employment income unless the member is not a manager of the LLC. Generally, 10 percent or less owners of a LLC are exempt from self-employment tax unless they receive a guaranteed payment for services rendered.

Ability to Provide Tax-Favored Fringe Benefits

A C corporation has the greatest ability to provide fringe benefits on a tax-favored basis. Most types of fringe benefits, and pension and profit-sharing plans receive tax-favored treatment in that they can be paid with pretax dollars and often do not generate current income to the recipient. Such benefits include life insurance (with limits), health insurance and medical expense reimbursement plans, certain death benefits, and meals and lodging, in limited circumstances. A corporation can also set up a cafeteria plan to let employees choose among various fringe benefits. This flexibility is much greater than that afforded partnerships and S corporations. In general, a partnership may deduct the cost of providing benefits to the owners, but the partners must include the value of such benefit in income. Thus, the only tax benefit may be income shifting among the partners. This same rule applies to 2 percent or greater shareholders of an S corporation. In addition, contributions by the corporation to a qualified pension plan may also be deductible when made but not currently taxable to the employee.

Sole proprietors, general partners, S corporation shareholder employees, and C corporation shareholder employees are all treated as employees for retirement plan purposes. A sole proprietor is treated as his or her own employer for retirement plan purposes. However, a partner is not an employer for retirement plan purposes; rather, the partnership is treated as the employer of each partner. Whether the entity chooses to fund retirement benefits with IRA-based plans, such as payroll deduction individual retirement accounts or annuities (IRAs); savings incentive match plans for employees (SIMPLE); or simplified employee pension plans (SEP); or with qualified plans, such as 401(k)s, profit-sharing, money-purchase, defined contribution or defined benefit plans, depends upon the desired funding level rather than upon any limitation imposed by the type of entity chosen.

Evaluating the Various Entity Forms

Although this may already be familiar to most practitioners, we provide a brief review here, as these issues pertain to the retirement plan arena.

The S Corporation

An S corporation is essentially identical to a C corporation in terms of the way it functions and with regard to the nontax consequences of doing business in corporate form. It offers investors limited liability and its operation and structure (a board of directors, officers, and shareholders) are similar to those of a C corporation. S corporations differ dramatically from C corporations with regard to tax matters. Unlike a C corporation, an S corporation is a pass-through entity. As such, the corporation essentially acts as a conduit through which items of tax attributes flow pro rata to shareholders. For startup corporations expected to generate losses in the early years, the S corporation is often preferable to a C corporation because losses from an S corporation flow through to shareholders and can be used to offset other income of the shareholders (or their spouses). Losses of a regular C corporation can only be used to offset profits earned in prior or subsequent tax years. Since a startup corporation has no prior profits to absorb losses, it must wait until some future profitable tax year to obtain any tax benefit from its losses. Double taxation of corporate earnings is avoided because there is generally no corporate-level income tax. Instead, earnings are taxed once at the shareholder level when earned regardless of when they are distributed.

Unlike a C corporation, an S corporation has limits on the number and types of permissible shareholders. It cannot have more than 100 shareholders, issue more than one class of stock, or have corporations, partnerships, nonresident aliens, and most types of trusts as shareholders. These restrictions, in turn, limit the transferability of shareholder interests in the corporation since a transfer to an ineligible shareholder would cause the S corporation to lose its S status. Thus, although an S corporation has distinct tax advantages over a C corporation, many enterprises may not qualify for its use.

Incorporated professional practices, such as doctors, accountants, and lawyers, are typically called professional corporations or professional associations depending on the governing state law or preferences of the owners. A professional corporation can be either a C corporation or an S corporation. Although use of an S corporation may eliminate double taxation, it does prevent the owners from utilizing the more generous employee benefits available to C corporation employees. From a tax perspective, the primary advantage of using a corporation is the availability of tax-free fringe benefits. However, this must be weighed against the necessity of distributing profits to the shareholder employees to avoid the double taxation of income. The only nontax advantage of a professional organization is the limited liability its members may receive. Specifically, professionals in a group practice may achieve limited liability for their partners' professional malpractice, thereby protecting themselves from another partner's error or negligence.

The General Partnership

A general partnership provides multiple owners with the least costly and simplest type of entity. A partnership is a noncorporate entity comprised of two or more owners. Unlike a corporation, it requires no formalities in order to exist. Further, there is generally no limit on the type or number of owners in a partnership. Unlike a C or S corporation, partners in a general partnership are personally liable for the partnership's obligations. General partnerships are pass-through entities, and although the partnership must file an information return and characterize certain tax items at the partnership level, the partners, not the entity, deduct partnership losses on their income tax returns. Further, the use of a partnership avoids the double taxation of earnings problem found in C corporations. A general partnership is also preferable over other business forms because of the flexibility in the composition of the partnership.

Another advantage of a partnership is that it can specially allocate items of income, deductions, and losses among partners non-pro rata, provided the tests of IRC Section 704(b) are met. A contributor of money or property to a partnership can be allocated a disproportionate amount of the losses that the contribution has financed. However, the allocation must have "substantial economic effect" in order for it to be respected for tax purposes. In contrast, the requirement that an S corporation have only one class of stock prevents it from making allocations of gain or loss that are disproportionate to the shareholder's ownership in the corporation. An S corporation can issue debt, but care must be taken that it not be susceptible to being treated for tax purposes as a second class of stock, which would disqualify the S corporation election. In addition, the regular payment of interest required by a debt instrument may not be suitable for a new business.

For both partnerships and S corporations, losses are passed through to the equity owners and deducted by them on their tax returns. A partner cannot deduct losses in excess of his adjusted basis in his partnership interest. However, this restriction usually does not cause a problem since partnership debt is included in the basis in a partnership interest. A shareholder of an S corporation cannot deduct losses in excess of his or her adjusted stock basis plus the adjusted basis of any loans made directly to the corporation. The basis of a shareholder's stock in an S corporation is not increased by the corporation's debt to third parties. Guarantees of corporate debt do not create basis until payments are actually made on the debt. This restriction on deductibility of a shareholder's losses from an S corporation is a significant limitation.

The Limited Partnership

The limited partnership offers the benefit of a partnership with the liability protection of a corporation. Like a corporate shareholder, limited partners in a limited partnership are not personally liable for the obligations of the partnership. The liability of the limited partners is limited to their financial investment in the enterprise. In addition, limited partnerships are pass-through entities that have no restrictions on the number or types of partners who may participate. In some cases, use of a limited partnership is preferable to a C corporation because the former has no entity-level tax. Thus, in contrast to a C corporation, its earnings are taxed once to the partners based on their respective distributive shares.

A major drawback of the limited partnership is the inability of the limited partners to participate in the management of the partnership. A limited partner may not vote on issues affecting the partnership's ordinary course of business. Because of the lack of participation in management, limited partners are subject to the passive loss rules of IRC Section 469. This severely restricts their ability to benefit from the tax credits and losses the entity may generate.

The Limited Liability Company

A LLC is a hybrid entity that is treated like a corporation for limited liability purposes, but is treated like a partnership for tax purposes. Like C corporations and limited partnerships, LLCs afford members limited liability. Unlike a limited partnership, a member of an LLC can participate in day-to-day management without losing limited liability. Equally important, an LLC, like an S corporation, is subject to only one level of taxation if properly structured. However, unlike an S corporation, there are no restrictions on the type or number of members. Despite all of the positive tax and nontax aspects of LLCs, there are some drawbacks. Because LLCs are creatures of state statute, legislation establishing and regulating these entities varies from state to state. This lack of uniformity among the states leads to unresolved tax and nontax issues.

The Limited Liability Partnership

A LLP is much like the LLC. In an LLP, a partner is not personally liable for malpractice or other tort related claims arising from the professional misconduct of another member of the LLP. In many states, professionals such as lawyers, doctors, CPAs cannot incorporate or form LLCs. The LLP was created to give professional services entities the advantages of limited liability protection while not absolving them from their own negligent actions.

Case Study

A comparison of the total income and Social Security taxes paid under each of the four entity choices was simulated for a hypothetical business owned by Dave and his spouse, Ellen, who file a joint tax return. Dave has a 90 percent ownership interest in the business and Ellen has a 10 percent ownership interest. Dave takes a salary from the business while Ellen is a passive investor and receives no salary. It is assumed that the entity was operated for five years and then liquidated at the end of the fifth year. For the corporate form, it is assumed that the stock is redeemed rather than sold. Since the entire gain upon liquidation is taxed to the S shareholders, no gain or loss is recognized upon redemption of their stock.

The net present value of the total tax cost for each of the four entity choices was computed using four entity choices and whether or not the maximum Section 179 election-to-expense deduction was taken in the first year of doing business. The simulation also compares the present value of the total tax assuming that realty contributed to the business appreciated at 20 percent or at 0 percent per year. For ease of comparison, the results of the 16 simulations are shown as a percentage of the total taxes paid as a sole proprietorship—that is the sole proprietor tax is set at 100 percent.

Present Value of Total Tax as a Percentage of Sole Proprietor Tax Using Different Combinations of Bonus Depreciation and the Election to Expense

Entity Choice	20 Percent	0 Percent
Asset Appreciation		
Maximum Election-to-Expense Deduction		
Sole Proprietor	100%	100%
Partnership	98%	98%
S Corporation	97%	97%
C Corporation	141%	105%

(continued)

Present Value of Total Tax as a Percentage of Sole Proprietor Tax Using Different Combinations of Bonus Depreciation and the Election to Expense
(continued)

Zero Election-to-Expense			
Sole Proprietor		100%	100%
Partnership		100%	100%
S Corporation		96%	95%
C Corporation		146%	111%

The simulations indicate a slight preference for the flow-through entity, either a partnership or an S corporation, since the total tax paid is less than 100 percent of the tax paid as a sole proprietor in six of the scenarios. The partnership (LLC) has the lowest present value of total taxes paid over the five-year time horizon when the maximum election to expense is claimed, primarily resulting from income attributable to the limited partner being exempt from self-employment tax. One possible disadvantage of the LLC is that any operating loss attributable to the limited partner is not currently deductible because of the passive loss limitations under IRC Section 469. However, the disallowance of the passive loss may work to the taxpayer's advantage if it can be carried over to future tax years in which the entity generates net passive income from the LLC.

If bonus depreciation is not elected, the S corporation is preferable to the partnership, because the total Social Security taxes paid on wages are less than those paid on the net self-employment income from the partnership.

Even though the tax treatment of fringe and retirement benefits favors using a regular C Corporation, it is the least favorable entity choice because current and liquidating dividend distributions are not deductible by the corporation. If the realty assets contributed to the partnership are appreciating at 20 percent per year, the built-in gain recognized in the year of sale causes the total tax of a regular C corporation to be between 41 percent and 46 percent more than the tax paid as a sole proprietor. If the assets are assumed to have no annual appreciation, the total tax of a regular C corporation is only 5 percent to 11 percent more than for the sole proprietor.

Conclusion

The choice-of-entity decision is a complex one with no one right answer for all businesses. It is important to weigh both the nontax and the tax factors when making this decision, including the net present value of the total tax cost of each entity choice. If nontax factors dictate that the corporate form be used, keeping appreciating assets, such as real estate, outside the corporation is preferable because of the corporate level tax on built-in gains. In lieu of contributing realty to the corporation, the shareholder could retain ownership of the assets and lease them to the corporation which would generate rental income and ensure that the gain upon their sale would be taxed only once. Also, it may be preferable to elect the maximum IRC Section 179 election-to-expense on all qualifying assets purchased during the tax year.

It is widely assumed that the corporate form of doing business is preferable if the tax treatment of retirement and fringe benefits are taken into consideration. Nevertheless, the smallest total tax liability over the life of the entity is achieved by choosing a flow-through entity, primarily because the double level tax on distributions can be avoided without adversely affecting retirement plan contributions.

Chapter 20

Deadlines for Depositing Employee Contributions and Loan Repayments

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This chapter primarily discusses the deadlines for making employee-derived contributions of plan assets to a plan under Department of Labor (DOL) and Internal Revenue Service (IRS) rules and regulations.

Overview

Amounts withheld from employees' pay must be deposited to the plan within a reasonable time. If deposits are not timely made, the late payment will be considered a prohibited transaction by virtue of the employer improperly having use of plan assets.

Plan Assets

The assets of the plan include amounts (other than union dues) that a participant or beneficiary pays to an employer, or amounts that a participant has withheld from his or her wages by an employer, for contribution to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets.¹ The DOL's deposit deadlines only apply to a plan covered by Title I of the Employee Retirement Income Security Act of 1974 (ERISA), *that is*, a plan which covers employees vs. a plan which covers a sole proprietor or solely partners².

¹ DOL Reg. Section 2510.3-102(a) [61 FR 41233, Aug. 7, 1996, as amended at 62 FR 62936, Nov. 25, 1997] for purposes of subtitle A and parts 1 and 4 of subtitle B of title I of ERISA and IRC Section 4975 only.

² DOL Reg. Section 2510.3-102(b)(1) and Section 2510.3-3(b).

Deposit Deadlines for Elective Deferrals

ERISA regulations generally require employee contributions to qualified plans and salary-reduction or elective simplified employee pension plans (SARSEP) to be deposited as soon as they can reasonably be segregated from the employer's general assets, but in no event later than the fifteenth *business day* of the month following the month in which such amounts would otherwise have been payable to the participant in cash.³ In the case of a savings incentive match plan for employees (SIMPLE) individual retirement account or annuity (IRA), however, the deposit must occur no later than the thirtieth *calendar* day following the month in which the participant contribution amounts would otherwise have been payable to the participant in cash.⁴ The term *business day* means any day other than a Saturday, Sunday, or any day designated as a holiday by the federal government.⁵

Note. In the case of a SIMPLE IRA and notwithstanding the above rule, elective contributions are only *deductible* for a year if made no later than the close of the 30 day-period following the last day of the month in which amounts would otherwise have been payable to the employee in cash.⁶ It is unclear whether amounts contributed after the 30-day period may be deducted in succeeding years.⁷ Unlike Code Section 404(h) that provided generally for a carryover of nondeductible SEP contributions, there is no express provision regarding nondeductible SIMPLE IRA contributions. Such amounts may also be subject to the 10 percent nondeductible contribution penalty tax.

These deadlines are not safe harbors but merely describe a maximum time period. The DOL believes this period could be as short as two days. In its preamble to the August 7, 1996 final regulations, the DOL indicated that the time period should be similar to that which an employer has for depositing withheld taxes, but acquiesced to comments regarding the difficulty in calculating allocations for transmittal.⁸ The DOL has not yet addressed the issue that the requirement is to remove the funds from the general assets of the plan sponsor, rather than to allocate the funds to individual accounts. A plan sponsor could quickly transmit funds to an omnibus account of the plan for later allocation and transmittal to individual accounts.

Example. Employer W is a small company with a small number of employees at a single payroll location. W maintains a plan under section 401(k) of the Code in which all of its employees participate. W's practice is to issue a single check to a trust that is maintained under the plan in the amount of the total withheld employee contributions within two business days of the date on which the employees are paid. In view of the relatively small number of employees and the fact that they are paid from a single location, W could reasonably be expected to transmit participant contributions to the trust within two days after the employees' wages are paid. Therefore, the assets of W's 401(k) plan include the participant contributions attributable to such pay periods as of the date two business days from the date the employees' wages are paid.⁹

³ DOL Reg. Section 2510.3-102(b)(1)], in the case of amounts withheld by an employer from a participant's wages.

⁴ DOL Reg. Section 2510.3-102(b)(2). IRC § 408(p)(1)(A), 408(p)(5)(A)(i). The IRC requires that elective contributions to a Simple IRA be deposited not later than the close of the 30-day period following the last day of the month with respect to which the contribution was made.

⁵ DOL Reg. Section 2510.3-102(e).

⁶ IRC § 408(p)(5)(A)(i); Runyan v. Commissioner, T.C. Summary Opinion 2006-58 (Apr. 19, 2006).

⁷ IRC §§ 408(m), 408(p)(5).

⁸ 61 FR 41220 (August 7, 1996)

⁹ DOL Reg. Section 2510.3-102(f)(1)

Under the DOL's Voluntary Fiduciary Correction Program (VFCP), discussed fully in Chapter 13, "Plan Correction Programs—EPCRS, VFCP, and DFVC," one of the examples demonstrates how a failure to deposit elective deferrals with two business days after a payday was a fiduciary breach.¹⁰ One court, at least, has been more lenient.¹¹ Prior deposit history appears to be significant in determining deposit deadlines. The IRS's Employee Plans Compliance Resolution System (EPCRS), discussed in Chapter 13, can also be used to correct qualification failures resulting from late deposits.

Contributions by Partners

After the DOL proposed plan asset regulations, the DOL received comments relating to when contributions by partners become plan assets. Under the final regulations, the monies that are to go to a qualified 401(k) plan by virtue of a partner's election become plan assets at the earliest date on which they can reasonably be segregated from the partnership's general assets after those monies would otherwise have been distributed to the partner, but no later than 15 business days after the month in which those monies would, but for the election to defer these amounts, have been distributed to the partner. (See DOL Reg. Section 2510.3-102, Preamble.)

The following example illustrates how the rule might apply to a qualified plan (or a SIMPLE IRA or grandfathered SARSEP) maintained by a partnership. It is unclear to what extent a sole proprietor can rely on the regulations.

Example. The Lucky-7 Partnership maintains an elective Internal Revenue Code (IRC or the Code) Section 401(k) plan (401(k) plan). On December 31, 2007, the last day of its taxable and plan year, all the partners are under the age of 50 and individually elect to defer the maximum amount into their 401(k)s (not to exceed \$15,500 for 2007 per partner). During the year, each partner had a monthly draw of \$2,000 cash against eventual earnings. The firm's accountant, Klondike, is ill and will not be able to compute Lucky-7's net earnings by the due date of Lucky-7's return; therefore, he files for an "automatic" 6-month extension on behalf of the partnership and each of the partners. On June 27, Klondike notifies the partnership that it indeed had a profit, and that each of the partners is due an additional \$37,000. Lucky-7 must deposit \$108,500 ($\$15,500 \times 7$) as contributions to the 401(k) plan of its seven partners as soon as the amounts can reasonably be segregated from the partnership's general assets, but no later than 15 business days after the end of June. For deduction purposes, the amounts must be deposited by October 15, 2008, the extended due date of Lucky-7's 2007 return.

Although very little guidance has been issued on this subject, the IRS has ruled that a partnership making periodic advances of earnings to each partner throughout the plan year (designed to be equivalent to periodic payments of compensation to each partner as if such partner were a common-law employee) could be contributed as elective contributions under a 401(k) plan, in which the partnership intended to withhold an amount from each partner's periodic advances pursuant to a deferral election.¹²

In most cases, participant contributions will become plan assets well in advance of the 15-day (30-day if SIMPLE IRA) outside deadline. With most payroll systems, employers are able to segregate wage-withholding amounts in a matter of days, if not almost immediately.

¹⁰ See example, VFCP Section 5, 67 Fed. Reg. 60 (March 28, 2002).

¹¹ See, *Golden v. wwwrrr, Inc.*, 2002 U.S. Dist. LEXIS 3053 (D. Minn. 2002). For a copy, see <http://www.nysd.uscourts.gov/courtweb/Pdf/D08MNXC/02-01788.PDF#xml>. For a discussion of this case, see, S. Derrin Watson, "Plan Assets Go wwwrrr," 9 *Journal of Pension Benefits* 4 (Panel/Aspen, NY 2002). See *McConnell v. Costigan*, 2002 WL 313528 (S.D.N.Y. Feb., 28, 2002) regarding damages (some contributions were up to 600 days late).

¹² IRS Ltr. Rul. 200247052 (Aug 28, 2002).

Ten-Day Extensions

An employer may extend the outside deadline under limited circumstances. With respect to participant contributions withheld by an employer in a single month, the outside deadline may be extended for ten additional business days, provided that within five business days after the end of the extended period, the employer provides written notice to participants stating:

1. That the employer elected to take such extension for that month.
2. That the affected contributions have been transmitted to the plan.
3. With particularity, the reasons why the employer could not reasonably segregate the participant contributions within the normal timeframe.¹³

The notice must be distributed in a manner reasonably designed to reach all the plan participants within five business days after the end of such extension period.

In addition, prior to the beginning of the extended period, the employer must obtain a performance bond or irrevocable letter of credit in favor of the plan and in an amount not less than the total amount of the participant contributions withheld by the employer in the previous month. The bond or letter must be guaranteed by a bank or similar institution that is supervised by the federal government or a state government and must remain in effect for three months after the month in which the extension period expires.¹⁴

Within five business days after the end of such extension period, a copy of the notice must also be provided to the secretary of labor, along with a certification that the notice was provided to the participants and that the bond or letter of credit was obtained.¹⁵

Limitation on Extensions

An employer cannot elect the 10-day extension more than twice a year unless the employer pays to the plan an amount representing interest on the participant contributions affected by the extension.¹⁶

Deposit Deadlines for Nonelective Employee Contributions

Nonelective employee contributions must be deposited as soon as they can reasonably be segregated from the employer's general assets, but in no event later than the fifteenth *business day* of the month following the month in which the participant contributions amounts are recorded.¹⁷

Deposit Deadlines for Loan Repayments

The DOL takes the position that untimely remittance of loan repayments is a prohibited transaction and occurs when loan repayments are made later than would be permitted under the participant contribution regulation.¹⁸

¹³ DOL Reg. Section 2510.3-102(d)(1).

¹⁴ DOL Reg. Section 2510.3-102(d)(2).

¹⁵ DOL Reg. Section 2510.3-102(d)(1).

¹⁶ DOL Reg. Section 2510.3-102(d)(3).

¹⁷ DOL Reg. Section 2510.3-102(b)(1)].

¹⁸ DOL Reg. Section 2510.3-102.

[I]t is the DOL's opinion that participant loan repayments, made to the employer for purposes of transmittal to the plan or withheld from employee wages by the employer for transmittal to the plan, become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer's general assets.

The DOL also said that, although the maximum periods for depositing participant contributions (i.e., the period ending with the fifteenth business day of the month following the month in which such contributions are received or withheld from wages) do not directly govern the repayment of participant loans, the DOL believes

that holding participant loan repayments beyond such periods would raise serious questions as to whether the employer forwarded the repayments to the plan as soon as they were reasonably segregable from its general assets.¹⁹

Employer Contribution Deadline

The deadline for depositing employer contributions and employer matching contributions into the plan's trust is determined first by looking to the plan document, which may include deadlines as a matter of plan design. If the plan document merely requires that employer contributions be made by the date required by law, as many plans do, then the deadline will be determined under IRC Section 404(a) regarding the contribution deadlines for deductibility. Under IRC Section 404(a), an employer generally must make its contribution before the due date of the employer's tax return (including extensions). These same rules generally apply to employer matching contributions attributable to deferrals made during the plan year, although most employers make their matching contributions much sooner than required by IRC Section 404(a). Often, matching contributions are calculated on a payroll-by-payroll basis and must be deposited sooner by plan design. These rules are in sharp contrast to the rule that requires elective deferrals to be deposited to the plan's trust as soon as they reasonably can be segregated from the employer's general assets.²⁰

Form 5500 Series Treatment of Late Deposits

Form 5500 Series²¹ instructions for 2006 require plan auditors to review deposits of participant contributions (e.g., elective deferrals) and to confirm that the employer has deposited the contributions timely.

One of the methods the DOL uses to regulate this requirement is the Form 5500. Question 4a on Financial Information Schedules H and I (small plan) inquires as to whether the employer has failed to deposit participant contributions in accordance with the time period prescribed by the regulations; i.e., the earliest date the employer can reasonably segregate the contributions from its general assets, but in no event later than the fifteenth business day of the month following the month in which the employer withheld the contributions from employee's paycheck.²²

¹⁹ DOL Adv. Op. 2002-02A (May 17, 2002) For a copy, see <http://www.dol.gov/ebsa/programs/ori/advisory2002/2002-02a.htm>.

²⁰ IRC Section 404(a)(6).

²¹ Form 5500, Annual Return/Report of Employee Benefit Plan. Plan administrators annually file this report containing information described in section 103 of ERISA. Also known as EBSA Form 1210-0110. See www.dol.gov/library/forms/go-us-dol-form.asp?FormNumber=250&OMBNumber=1210-0110.

²² Prior versions of Schedules H and I address whether the employer had deposited the contributions within the maximum time period permitted in the regulations. To eliminate confusion, the DOL removed the word *maximum* from question 4a, beginning in 2002. The previous language erroneously suggested that employers have until the fifteenth business day of the following month to deposit the participant contributions, even if the contributions could have been segregated sooner.

Auditor's Confirmation

The 2006 Schedule H and I instructions require a plan auditor to confirm the accuracy of the employer's response to question 4a. If an employer answers question 4a with a *no*, the plan auditor must determine whether the employer has responded to the question on line 4a in accordance with the regulations. In other words, the auditor will need to review the deposits to determine whether the deposits were in fact made timely. The auditor then must disclose on the audit report his or her determination in accordance with generally accepted auditing standards.

Obviously, if the auditor's opinion does not agree with the response in line 4a, the preparer either must change its response or anticipate a DOL investigation.

Small plans that qualify for the audit waiver under line 4k do not have to be concerned with the plan auditor review, but must nonetheless respond truthfully.

Prohibited Transaction Implications

The DOL no longer requires an employer to report late deposits of participant contributions as prohibited transactions on line 4d of Schedules H and I, and Schedule G (financial transaction information for large plans). Apparently, the DOL feels that reporting the late deposits on line 4a is sufficient. Although an employer no longer reports the late deposits as a prohibited transaction on Schedule G, the employer still must correct the prohibited transaction and file Form 5330 to pay the excise tax. For large plans (and small plans which are ineligible for the audit waiver), the DOL continues to require the auditor's opinion to cover the delinquent participant contributions.

If an employer corrects the late deposit of participant contributions by filing under the VFCP, discussed in Chapter 13, the employer does not have to pay the prohibited transaction excise tax. Even if the employer qualifies for the excise tax exemption, the employer must report the late deposit on question 4a (i.e., answering question 4a with a *yes*).

Compared to the cost of preparing and submitting an application under the VFCP, most employers will pay the excise tax and correct the deficiency using the methodology of the VFCP without filing under the program. To address the *yes* response in question 4a, the preparer should include a footnote to Schedule H or, as applicable to notify the DOL that full correction utilizing the methodology provided under the VFCP program has taken place.

In the event the plan sponsor is required to pay the 15 percent excise tax under IRC section 4975, the IRS has stated that the interest rate for underpayments described IRC Section 6621(a)(2) on the date of the prohibited transaction is an appropriate rate used to calculate the amount involved.²³

²³ Rev. Rul. 2006-38, 2006-48 I.R.B. 977

Chapter 21

Beneficiary Designations

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A participant's use of his or her valuable right under a retirement plan to name a beneficiary is an important part of estate planning. Because a retirement benefit is not transferred by a will, a beneficiary designation affects a person's overall estate plan. This chapter explains some of the rules for making a beneficiary designation, including marriage and family rights that can restrain a beneficiary designation.

Many people mistakenly assume that they lack enough wealth for estate tax issues to be of concern, even when one or more estate, inheritance, or other transfer taxes likely will apply. This chapter, therefore, discusses a few simple tax-oriented estate planning concepts.

The chapter includes an explanation of how CPAs may advise clients about beneficiary designations, and concludes with a top-ten list of common mistakes that CPAs can help clients avoid.¹

CPA Practices

In addition to the basics of beneficiary designations, a CPA should be aware of the following:

- If a CPA's consulting engagements include estate planning, he or she must understand beneficiary designations to render competent tax advice.²

¹ *Author's Note.* Given federal and state laws that prohibit or otherwise preclude a person who is not a lawyer from giving legal advice, this chapter assumes that a CPA who is not a lawyer must sometimes refrain from giving advice, even when a CPA might be competent to render advice. The author asks readers to understand that this description of the law does not reflect his view about what the law ought to be. Rather, he believes that any person should be free to give legal advice (and to bear responsibility for his, her, or its advice). A CPA should present any suggestions carefully, and in a manner that follows certified public accountants' rules and standards.

² Statement on Standards for Tax Services No. 8, *Form and Content of Advice to Taxpayers* (AICPA, Professional Publications, vol. 2, TS sec. 800). See also Department of the Treasury, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service, 31 C.F.R. Part 10 (2005) ["Circular 230"].

- If a CPA performs personal financial planning engagements, he or she must understand beneficiary designations to render competent advice about how a client may use his or her resources to meet his or her financial goals.³
- Even a practitioner who does not perform personal financial planning can help clients spot common mistakes in making beneficiary designations, discussed later. This practical advice might earn clients' respect and loyalty.
- If a CPA performs audit, review, or controls-testing engagements for retirement plans, he or she needs to be ready to examine and advise clients about how to design prudent procedures for collecting and checking beneficiary designations.⁴

Even if a CPA does not perform any of these practices, he or she might prefer to maintain general awareness of laws concerning beneficiary designations because, far more than probate transfers, beneficiary designations are the primary means most Americans use to pass wealth.

Many of the explanations in this chapter will make better sense to the reader if he or she keeps in mind a few general principles and some special language of retirement plans.

ERISA Preemption

As explained in Chapter 23 (“Fiduciary Duties to Retirement Plans”), most employment-based retirement plans are governed by the federal *Employee Retirement Income Security Act of 1974*, as amended (ERISA).⁵ ERISA federalizes the law of employee-benefit plans. For an employer that has employees and former employees who live in many states, it would be burdensome to apply many different state laws. Even for a smaller employer that has employees and former employees concentrated in only a few states or even one state, it might be difficult to administer a plan following state laws.⁶ So, ERISA preempts state laws.⁷

The ERISA preemption rule is one of the fundamentals of the law of retirement plans. A reader will notice that almost every rule or explanation concerning beneficiary designations under a retirement plan has two different answers. For an ERISA-governed plan (as described in the following text), only ERISA and the plan's documents apply.⁸ For a non-ERISA plan, one or more states' laws might apply.

ERISA or State Law

Many rules for beneficiary designations are common to all kinds of retirement plans. For some of the rules that are not common to all kinds of retirement plans, this chapter explains the difference. Also, this chapter explains the differences between ERISA, which governs most employment-based retirement plans, and state

³ See generally, American Institute of Certified Public Accountants, Code of Professional Conduct, Rule 201, *General Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 201.01), and accompanying Interpretations.

⁴ AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, paragraph 9.02b (2007).

⁵ The nontax provisions of ERISA are codified as 29 U.S.C. Sections 1001-1191c and 1201-1461. Because most publications used by employee-benefits practitioners cite ERISA's Act sections, this chapter's citations are to the Act sections.

⁶ Even when all of an employer's employees both work and reside in only one state, it still would be burdensome for an employer, especially a small-business employer, to administer a retirement plan following state laws. This is because employers rely on service providers that design their business plans and work methods for national standards. Any variation that could be based on an employer's, employee's, participant's, beneficiary's, or alternate payee's residence would result in significant inefficiencies.

⁷ ERISA preempts state laws that relate to an employee-benefit plan. ERISA Section 514(a). An exception recognizes laws that regulate banking, insurance, or securities. ERISA Section 514(b)(2). ERISA does not preempt “any generally applicable criminal law of a State.” ERISA Section 514(b)(4).

⁸ Along with ERISA's preemption of state laws, ERISA Section 404(a)(1)(D) requires that an employer administer the plan according to the plan's documents. See Chapter 23—Fiduciary Duties to Retirement Plans.

law, which governs most IRAs. State law also governs church plans and governmental plans, but because this book is about retirement plans for smaller businesses, this chapter does not focus on plans sponsored by charity, church, and governmental employers. For a reader's convenience, in each topic this chapter explains first the rule for ERISA plans, and then explains state law.

Definitions

For the reader's convenience, this chapter uses some shorthand terms. The author hopes this usage will make sense in context. Because the chapter covers many different kinds of retirement plans, readers will be better prepared to understand this information if they first refer to the definitions that follow:

- *ERISA plan* refers to a *retirement plan* (see below) that is governed by ERISA.
- *Non-ERISA plan* refers to a retirement plan (including an IRA) that is not an ERISA plan.
- *Nonprobate* refers to property that is transferred or contract rights that are provided without a probate administration, which is described in the following text.
- *Participant* refers to a participant (rather than a beneficiary or alternate payee) under a retirement plan, or the original owner of an individual retirement account or annuity (IRA).
- *Payer* refers to any trustee, custodian, bank, broker-dealer, insurer, plan administrator, or other person responsible to decide or pay a claim under or regarding a retirement plan.
- *Probate* refers to a transfer of property or rights through a court-supervised administration or succession.
- *Retirement plan or plan* refers to a plan or arrangement that is one of the following:
 - Qualified plan under Internal Revenue Code (IRC) Section 401(a)
 - Cash or deferred arrangement under IRC Section 401(k)
 - Individual retirement account under IRC Section 408(a)
 - Individual retirement annuity under IRC Section 408(b)
 - Simplified employee pension plan (SEP) under IRC Section 408(k)
 - Salary-reduction SEP (SARSEP) under IRC Section 408(k)(6)
 - Savings incentive match plan for employees (SIMPLE) under IRC Section 408(p)

Except for differences between ERISA and state law (explained below), beneficiary designation rules apply in a similar manner to these different retirement plans.

- *State*. This chapter uses the word *state* in its popular meaning to include the District of Columbia or any state, commonwealth, territory, possession, or similar jurisdiction within the United States of America. Because this chapter has many references to state law, this chapter uses only the word *state* (rather than the legal term *jurisdiction*) for reading ease. For example, although the District of Columbia is not a state, law that applies to a person because he or she resides in the District is state law, as distinguished from United States law or federal law that applies throughout the United States of America.

About Beneficiary Designations

A retirement plan includes a provision by which a participant may name his or her beneficiary or beneficiaries. The beneficiary designation applies, even if the participant's will states a contrary disposition. Although that outcome results simply from applying the terms of a plan, some states for convenience include an explicit provision in the probate statute. Also, courts have held that a will may not override a beneficiary designation.

- *ERISA*. For an ERISA plan, only the plan's provisions govern a beneficiary designation.
- *State Law*. For a non-ERISA plan, state law may supplement a plan's provisions concerning the manner of making a beneficiary designation. For example, New York law requires that a beneficiary designation be signed.

Note. If the state law of the State of Washington applies, a beneficiary's right under a non-ERISA plan arguably is subject to Washington's *Testamentary Disposition of Nonprobate Assets Act*.⁹

Other Reasons Why a Participant Would Want to Name a Beneficiary

Following the federal *Pension Protection Act of 2006*, there are at least two kinds of benefits—other than the death benefit itself—that might be obtained by naming a beneficiary.

A beneficiary, even if he or she is not a surviving spouse, may direct a rollover. If a plan so provides, a *designated* beneficiary, even if he or she is not the participant's surviving spouse, may instruct a direct rollover into his or her IRA.¹⁰

Caution: A state might have an income tax law that does not follow the Internal Revenue Code. Before a beneficiary directs a rollover (or even decides to take a distribution), he or she should get expert advice about whether each state of which he or she is a resident or a domiciliary¹¹ would recognize the rollover, or would tax the distribution, even if rolled over for federal income tax purposes.

A hardship or emergency distribution can be based on the need of a beneficiary who is not a spouse or dependent. Without waiting for a participant to meet a plan's severance or other conditions that may permit a retirement distribution, a plan may permit a payment to meet a participant's hardship or emergency. This kind of distribution must be based on the participant's need, which can include some needs concerning a participant's spouse or dependent. Further, a plan may provide that an event (including a medical expense) that would meet the plan's hardship or emergency conditions if it happened concerning the participant's spouse or dependent meets the conditions if it happens concerning "a person who is a beneficiary under the plan with respect to the participant."¹² In the Internal Revenue Service's view, such a rule applies only concerning a primary beneficiary—that is, one who "has an unconditional right to all or a portion of the participant's account balance under the plan upon the death of the participant."¹³

Practice Pointer: Nothing in the Internal Revenue Code requires a plan sponsor to make either of these changes, but many will want to.

⁹ See Wash. Rev. Code §§ 11.11.003 to 11.11.903.

¹⁰ IRC § 402(c)(11).

¹¹ See 4 U.S.C. § 114.

¹² Public Law 109-280, § 826 (August 17, 2006).

¹³ IRS Notice 2007-7, 2007-5 I.R.B. 395 (Jan. 29, 2007) at Q&A-5(a).

Note. In California, Connecticut, Hawaii, Maine, Massachusetts, New Jersey, or Vermont, state law might require a non-ERISA plan that allows a direct rollover by an opposite-sex spouse to include this beneficiary-rollover provision to the extent that the provision is needed so that the plan does not discriminate against an opposite-sex marriage, civil union, or domestic partnership that has legal rights and burdens equal to another marriage.

Using Trusts

A participant may not hold his or her retirement benefit in a living trust¹⁴ A retirement plan provides that a participant may not assign or transfer any right he or she has under the plan. Because its maker may revoke or change a living trust, the trust declaration or agreement could not assure that during the participant's lifetime the retirement benefit must be used only for the participant's benefit.

Moreover, there is no need to put a retirement benefit into a living trust. A retirement plan benefit is nonprobate property that will pass according to the plan's beneficiary designation.

A participant may name a trust as beneficiary under a retirement plan. To make a correct beneficiary designation, the participant should name the trustee, as trustee of the trust, as beneficiary. The trust must be legally in existence (or completed such that it would be legally in existence on the trustee's receipt of money or property) before the participant makes the beneficiary designation.

Practice Pointer: A beneficiary of a trust will not be a designated beneficiary under a retirement plan's minimum required distribution (MRD) rules unless the trust meets conditions and certifies to the plan administrator (if any) information specified in the federal tax regulations. See chapter 14: "Required Minimum Distributions."

Making a Beneficiary Designation

Ordinarily, only a participant may make a beneficiary designation.

A plan may permit a beneficiary to name a further contingent beneficiary if the participant had not (before his or her death) designated all of the benefit and the plan lacked any other default provision (see below).¹⁵ Such a provision can cause the benefit that remains undistributed at each beneficiary's death to be subject to federal estate tax (and state inheritance tax), notwithstanding that the same benefit was previously so taxed on the participant's (and earlier beneficiaries') death.¹⁶ A federal estate tax may be postponed if a beneficiary names his or her spouse as the succeeding beneficiary and that spouse has the power (legal right) to take the entire remaining benefit.¹⁷

¹⁴ A living trust (also called an *inter vivos* trust) is a trust established and in effect during the lifetime of the grantor; as opposed to a testamentary trust, which takes effect upon the death of the grantor. A living trust can be revocable or irrevocable (but the kind of living trust that many people use as a partial substitute for a will is usually revocable).

¹⁵ See Ltr. Rul. 199936052 (June 16, 1999), concerning an IRA.

¹⁶ IRC Section 2041(a)(2); Treas. Reg. Section 20.2041-1(b).

¹⁷ IRC Section 2056; Ltr. Rul. 199936052 (June 16, 1999).

Practice Pointer: A careful participant will make a complete beneficiary designation that contemplates possibilities that are not remote. If a participant does not want to specify alternate takers, he or she could create a trust, which could include a power of appointment for a beneficiary to name a further beneficiary.¹⁸

ERISA

A retirement plan administrator may accept a beneficiary designation made by a participant's agent under a power of attorney, but need not do so. Typically, a plan administrator will decline to act unless the power-of-attorney document expressly states a power to change beneficiary designations.

State Law

An IRA payer may (and sometimes must) accept a beneficiary designation made by an agent under a power of attorney. For an IRA, state law governs whether a payer may or must permit the actions of an agent under a power of attorney.

Caution: *An IRA might provide that the participant cannot act by an agent.*

In some states, banking law regulates how a bank or trust company must evaluate whether to honor a power of attorney.

Practice Pointer: A practitioner should consider which state's law might apply, and a client should consider instructing his or her lawyer to draft a power-of-attorney document to meet the state laws of all states that might be involved.

Example. Bill resides in Pennsylvania, but works in Ohio. The IRA that Bill selected to receive his employer's SEP contributions provides that the IRA is governed by Massachusetts laws.¹⁹ Rather than assume that a power of attorney that meets the requirements of Pennsylvania's statute would be sufficient, Bill's lawyer drafts a document that conforms not only to Pennsylvania laws but also to Massachusetts and Ohio laws. Doing so is less expensive than researching which law would apply. Following several states' laws gives Bill a better likelihood that his document will be relied on.

Substantial-Compliance Doctrine

When recognized, the doctrine of substantial compliance might excuse a participant's failure to effect a change of beneficiary according to a plan's terms if he or she intended to change his or her beneficiary and did everything reasonably in his or her power to effect the change. Courts find that this equitable doctrine

¹⁸ If a participant who creates such a trust has a spouse, he or she might consider whether the trust might, in some circumstances, provide a benefit for the spouse, and (if so) whether it is desirable for the trust's provisions to preserve one or more ways to obtain the federal estate tax marital deduction. Treasury Regulations Section 20.2056(b)-5(f)(6) provides that, concerning a trust that was created during the decedent's life, it does not matter whether the trust provided the participant's spouse a power of appointment before the participant's death. Further, this regulation provides that if a trust may be ended during the life of the surviving spouse by his or her exercise of a power of appointment or a distribution of the corpus to him or her, an interest passing in trust meets the condition that the spouse must be entitled to all income from the marital-deduction property if the spouse is entitled to the income until the trust ends, or has the right, exercisable in all events, to have the corpus distributed to him or her at any time during his or her life. See also Ltr. Rul. 199936052 (June 16, 1999).

¹⁹ Mass-market IRA agreements often include a governing-law clause. The state law selected in such a clause usually is the law of the state in which the financial services business is headquartered. A quick survey of state-law selections proposed by a few widely recognized businesses illustrates the point: Ameriprise (Minnesota), Fidelity Investments (Massachusetts), T. Rowe Price (Maryland), Vanguard (Pennsylvania).

of substantial compliance circumvents “a formalistic, overly technical adherence to the exact words of the change of beneficiary provision in a given [contract].”²⁰

A payer’s interpleader (or other circumstances that make a payer a mere stakeholder) does not change the burden of proof; a claimant must show the participant’s substantial compliance with the plan’s procedure for making a beneficiary designation.

Practice Pointer: To avoid this problem, a CPA should ask a client about beneficiary designations at each personal financial planning review.

ERISA

For an ERISA plan, the doctrine of substantial compliance should apply only if the plan administrator in its discretion decides to use such a concept to aid its own interpretation or administration of the plan.

Concerning an ERISA plan, a court should hold that ERISA preempts a state’s doctrine of substantial compliance. However, some federal courts have held that a state’s common-law doctrine of substantial compliance supplements an ERISA plan’s provisions. In the absence of findings by the plan administrator, a federal court found that a state’s doctrine of substantial compliance may be replaced by a federal common-law doctrine of substantial compliance. Although some federal courts considering the question have held that ERISA does not necessarily preempt a state’s doctrine of substantial compliance, that view is incorrect. Still, a CPA must be aware that federal courts often render wrong decisions.

Unless a plan provision is contrary to ERISA, an ERISA plan administrator should administer a plan according to the plan’s documents.²¹ Therefore, if a plan states that any doctrine of substantial compliance will not apply, the plan administrator must interpret and administer the plan without using such a doctrine.

Practice Pointer: Some plan documents say that the doctrine of substantial compliance will not apply. So it is important for a CPA to urge a client to pay attention to his or her beneficiary designations.

Further, if a plan grants the plan administrator discretion in interpreting or administering the plan, a court will not interfere with the plan administrator’s decision unless it was an abuse of discretion.

State Law

For a non-ERISA plan, a state court likely would apply the state’s doctrine of substantial compliance. Therefore, the doctrine of substantial compliance usually applies to a defective beneficiary designation for an IRA not held under an ERISA plan.

Default Beneficiary Designation

A plan usually will provide for a default beneficiary designation that applies when the participant has not made a valid beneficiary designation. A typical provision pays the nondesignated benefit to the executor of the participant’s probate estate.

²⁰ *Phoenix Mutual Life Insurance Co. v. Adams*, 30 F.3d 554, 563 (4th Cir. 1994).

²¹ See Chapter 23—Fiduciary Duties to Retirement Plans.

Practice Pointer: Do not let a client's family suffer the inconvenience of requiring an administrator to figure out a plan's default provision. Instead, remind a client to make and keep up-to-date his or her beneficiary designations.

If a participant's estate closed before a plan's payment occurs, a court may reopen the estate for subsequent administration on the discovery of property that was not disposed by the previous administration.

If, applying community-property law (see below), a portion of a participant's benefit belongs or belonged to the participant's spouse, the spouse (or the spouse's beneficiaries or heirs) might have a claim against the participant's executor or personal representative for payment of the spouse's community property. Also, in some states, a law based on the *Uniform Disposition of Community Property Rights at Death Act* might apply.

Lost Beneficiary Designation

If a plan administrator cannot locate a beneficiary designation because the plan's records were destroyed, the plan administrator should try to "reconstruct" the beneficiary designation using the best evidence available to it.

That records are lost or destroyed does not discharge a plan administrator from its duty to administer the plan. When deciding whether to pay any benefit to a potential beneficiary, a plan administrator must act in good faith and must use reasonable procedures, especially when deciding who is a participant's beneficiary. When a record is lost or destroyed, a plan administrator may use the most reliable evidence available to it. For example, a service provider might have a copy of a beneficiary designation. Or a claimant might furnish a copy of a beneficiary designation. A plan administrator might use its discretion to rely on a document that appears to be a copy of a participant's beneficiary designation. But a plan administrator should do so only if it has adopted and uses reasonable procedures designed to detect a forgery. Further, when a claimant submits evidence that he or she is the participant's beneficiary, a plan administrator must take reasonable steps to consider whether the evidence is credible.

Practice Pointer: A CPA should suggest to a client that he or she give a copy of a designation to the beneficiary.

Understanding principles of disaster recovery and protection through deliberate redundancy, a CPA should suggest to a client plan administrator that it keep an *extra* copy of a plan's beneficiary designations at a location geographically distinct from the plan administrator's regular location.

Laws and External Documents That Might Affect a Beneficiary Designation

A retirement plan's beneficiary regime should be designed to minimize the situations in which a plan administrator or payer should need to consider anything beyond the plan's provisions and the beneficiary designation filed with the plan administrator. However, sometimes it is impossible to avoid the demands of other laws.

Divorce as Revocation of a Beneficiary Designation

Whether a divorce revokes a beneficiary designation turns on whether ERISA or state law governs the retirement plan.

ERISA

For an ERISA plan, ERISA preempts state laws. Therefore, only a plan's terms will govern whether a divorce or other circumstance has any effect on the plan beneficiary designation.

A qualified domestic-relations order (QDRO) does not preclude a participant from continuing a beneficiary designation that provides for his or her former spouse.

Practice Pointer: A CPA might remind his or her client, after a divorce, to change or confirm the client's beneficiary designations.

State Law

For a non-ERISA plan, state law might apply. In many states, a divorce will not revoke a beneficiary designation that names the ex-spouse. In other states, a statute might provide that a divorce or annulment has the effect of making a former spouse not a beneficiary, except as otherwise provided by a court order. Even when the relevant state has such a statute, it might not apply if the plan has contrary provisions, and many plans include a provision that a divorce or anything other than the plan's beneficiary designation form has no effect on the beneficiary designation. Further, the law of the state in which a participant resided when he or she died is not necessarily the governing law.

Practice Pointer: Many investment managers are based in Boston or New York; many securities broker-dealers prefer New York law, and many trust companies prefer Delaware law. Because an IRA usually is a printed-form contract offered by its custodian, Delaware, Massachusetts, or New York law often is an IRA's governing law. If the law of one of those states applies, a divorce does not revoke a beneficiary designation of a former spouse—even if the IRA participant resides in a state with a statute that a divorce revokes a beneficiary designation of the former spouse.

In any case, state law will protect a payer that pays the beneficiary of record unless the payer has received a court order restraining payment or at least a written notice that states a dispute about who is the lawful beneficiary.

Beneficiary Designation Contrary to an External Agreement

A plan administrator pays according to the plan's provisions, and need not consider external documents.

ERISA

For an ERISA plan, ERISA preempts state laws that otherwise might affect who gets a plan benefit.

State Law

For a non-ERISA plan, a plan administrator also pays according to the plan's provisions, and ordinarily need not consider external documents (other than a court order that applies to the administrator). However, once a non-ERISA plan has paid the plan beneficiary, a person who has rights under an external agreement may pursue remedies under state law.

Executors

An executor often may not participate in a court proceeding concerning a disputed benefit. A personal representative of a participant's estate may participate in a court proceeding concerning a disputed benefit only if the personal representative is a bona fide claimant. But if a personal representative does not make any claim of right to the benefit, such a personal representative has no claim that a court will consider and thus no standing to participate in a court proceeding.

When a Beneficiary Is a Minor

A divorced person might not want to name his or her young child as a beneficiary if doing so might have the effect of putting money in the hands of the child's other parent, namely, the participant's former spouse.

A payer wants to be sure that a payment is a complete satisfaction of the contract. Ordinarily, a beneficiary's deposit or negotiation of a check is the beneficiary's acceptance of the satisfaction of the beneficiary's claim.

A minor is a person still young enough that he or she cannot make a binding contract. While state laws vary, almost all end a person's minor status at age 18. The only states with an older age of competence are Alabama –19, Mississippi –21, and Nebraska –19. Usually, a minor's emancipation from his or her parents does not change the minor's lack of power to make binding contracts.

Before a child reaches age 18 (or the other age of competence to make binding contracts), his or her guardian or conservator may disaffirm an agreement or promise the child made. After a child reaches age 18 (or the other legal age), he or she may disaffirm an agreement or promise he or she made before he or she reached the age of competence to make contracts.

If state law applies, a payer will not take the risk that a payment is not a complete satisfaction of plan obligations. Even if ERISA preempts state law, a plan administrator might be concerned that a court would fashion a federal common-law rule. Thus, plan administrators, employers, and payers almost universally are unwilling to pay benefits to a minor.

To facilitate payment in these circumstances, most retirement plans permit payment to a minor's conservator, guardian, or *Uniform Transfers to Minors Act* custodian. If a participant named his or her child as a beneficiary (rather than naming as beneficiary a custodian), a plan administrator or payer is likely to honor a claim made by the child's guardian. If a child's other parent is living, most courts would appoint the parent as the child's conservator. In some states, the law presumes that a parent is a child's natural guardian and conservator.

Practice Pointer: If a person does not want his or her child's other parent to get the child's money, suggest that such a participant name a custodian as his or her beneficiary.

Family Rights That Restrain a Beneficiary Designation

Federal and state laws provide some minimum property rights for a decedent's surviving spouse. State laws provide some minimum property rights for a decedent's surviving spouse and, sometimes, his or her children. If other dispositions of a decedent's property are not enough to meet such a property claim of a surviving spouse or child, federal or state law (whichever applies) might use a participant's retirement plan benefit as needed to meet these entitlements.

Failing to Provide for a Spouse

ERISA

Under an ERISA plan, a participant's beneficiary designation that fails to provide for his or her spouse will be invalid, for either 100 percent of the death benefit or the value of the plan's qualified preretirement survivor annuity (QPSA), whichever is provided by the plan, unless the participant made a qualified election that was supported by the spouse's notarized consent.²²

²² ERISA Section 205.

State Law

If a non-ERISA plan does not require a spouse's consent, a plan administrator or payer will, in the absence of any court order or written notice of a dispute, give effect to the participant's beneficiary designation. Even when a participant's beneficiary change has an obvious potential to frustrate a divorcing spouse's equitable-distribution rights, a participant remains free to make his or her beneficiary designation unless a court's restraining order binds him or her. Further, an order that binds a participant might not bind a plan or its administrator.

If a participant's surviving spouse did not receive his or her elective share (see below) provided by state law, a distributee is liable to the participant's executor or spouse if state law provides for a spouse's elective share to be payable from nonprobate property.

If a participant's surviving spouse did not receive his or her community-property share (see below) provided by state law, a distributee is liable to the participant's executor or spouse.

Practice Pointer: If a distributee received a plan distribution in one year but paid over an amount to the participant's surviving spouse in a later year, the distributee recognizes income for the year he or she received the distribution and claims a deduction for the year he or she paid restoration to the surviving spouse.

Caution: *A surviving spouse who is not the participant's named beneficiary and instead receives a retirement benefit because of an elective-share or community-property law is not a designated beneficiary when applying the plan's minimum-distribution provisions. Thus, it might become necessary to compute a minimum distribution by reference to a different person's life.*

In Louisiana, a plan administrator may follow the participant's beneficiary designation. However, a distributee who receives benefits under an IRA or another non-ERISA plan must account for and pay over benefits to the participant's surviving spouse if payment is necessary to satisfy the spouse's community-property rights and usufruct. A distributee who receives benefits under a retirement plan of "any public or governmental employer" is not subject to the claims of forced heirs.

Different law may apply for members of a Native American Indian tribe. However, a Native American Indian tribe's law usually applies between or among members of the tribe, and often cannot be enforced against a person outside the tribe.

Usually, a plan administrator need not tell an ex-spouse when a participant changes his or her beneficiary designation, even if a participant violates a court order in doing so. In the absence of a court order that commands the plan administrator to furnish specified information, a plan administrator has no duty to furnish information about a particular beneficiary designation change.

Failing to Provide for a Child

Under either an ERISA plan or a non-ERISA plan, a participant almost always is not required to provide for his or her child.

ERISA

Unless a plan states its own provisions, nothing in ERISA requires a participant to name his or her child as a beneficiary. ERISA preempts state laws concerning an ERISA plan's retirement benefits.

State Law

A participant may make a beneficiary designation that does not provide for his or her child. In the United States, only Louisiana and Puerto Rico have a forced-share provision for a decedent's children. Therefore, a person usually may "disinherit" his or her children. In some states, a modest family allowance (typically \$10,000) is required for a decedent's children if there is no surviving spouse.

In Louisiana, a plan administrator may follow the participant's beneficiary designation. But a distributee who receives benefits under an IRA or other non-ERISA plan must account for and pay over benefits to the participant's surviving spouse if payment is necessary to satisfy the spouse's community-property rights and usufruct and to the participant's children or forced heirs if payment is necessary to satisfy their required portions.²³

Practice Pointer: If a client resides in a nation other than the United States and wants to make a beneficiary designation that does not provide for his or her spouse and children, a CPA should urge the client to get an expert lawyer's advice.

Spouse's Rights

A participant's surviving spouse might have rights to a participant's retirement benefit in one of the following ways:

- Survivor-annuity or spouse's consent rights provided by the plan
- Elective-share rights under state law (see below)
- Community-property rights under state law (see below)

ERISA Survivor Benefits or Spouse's Consent Rights

An ERISA plan must provide some kind of benefit to a participant's spouse. The form of the required benefit turns on whether a distribution begins because of the participant's retirement or death and relates to the plan's payment options and some relation provisions.²⁴

For a distribution that begins before a participant's death, a plan must, unless an exception applies, provide a qualified joint and survivor annuity.

Ordinarily, a defined contribution plan that is not governed by ERISA funding standards need not provide a qualified joint and survivor annuity (QJSA) as long as a participant does not elect that his or her retirement benefit be paid as a life annuity.

If a plan provides a life annuity as a normal form of benefit, a plan sponsor may amend the plan to provide that every annuity is an optional form of benefit, or to eliminate every annuity option. Such an amendment is not a cutback of accrued benefits.²⁵ Once the amendment is effective, the plan need not provide a QJSA unless (if the plan permits) a participant affirmatively chooses it or chooses a different life annuity and fails to deliver a qualified election.

²³ See *Eskine v. Eskine*, 518 So. 2d 505, 508 (La. 1988).

²⁴ This general rule, and its exceptions and variations, are stated in ERISA Section 205.

²⁵ ERISA Section 204(g)(2)(B); Treas. Reg. Section 1.411(d)-4, Q&A-2(e). For this and other ERISA vesting rules, a federal government reorganization plan provides that the secretary of the treasury, rather than the secretary of labor, makes rules to interpret both ERISA's and the Internal Revenue Code's provisions.

Practice Pointer: A CPA should thoroughly consider all significant tax treatments before suggesting that a participant choose a single sum or other short-term payout. In some states, only a life annuity or periodic payments similar to a life annuity will qualify for favorable treatment as a pension under state income tax laws.

For a distribution that begins after a participant's death, a plan must provide a qualified pre-retirement survivor annuity or an alternate survivor benefit.

Qualified Joint and Survivor Annuity

A qualified joint and survivor annuity is an annuity for the participant's life, with a survivor annuity for the surviving spouse's life. The periodic payment of the survivor annuity must be no less than 50 percent (and no more than 100 percent) of the payment during the joint lives of the participant and spouse. A qualified joint and survivor annuity is the actuarial equivalent of an annuity on only the participant's life.

Qualified Preretirement Survivor Annuity

For a defined contribution plan, a qualified preretirement survivor annuity is the annuity that results from using no less than half the participant's vested account balance to buy an annuity for the surviving spouse's life.

Alternative Survivor Benefit

For a defined contribution plan that is not governed by ERISA funding standards, a plan may omit both a qualified joint and survivor annuity and a qualified preretirement survivor annuity if the plan (in addition to meeting other conditions) provides that, absent a qualified election, the benefit that remains after a participant's death belongs to the participant's surviving spouse.

Qualified Election

An ERISA plan must include a provision that assures a participant's surviving spouse some retirement income after the participant's death, and must include a provision that assures a survivor benefit if the participant dies before he or she receives or begins a distribution. A plan must permit a participant to "waive" one or more of these benefits. To do so, a participant must deliver to the plan administrator a qualified election. Ordinarily, such an election has no effect unless the participant's spouse consents to the election. Also, a participant's qualified election must meet several form, content, and procedure requirements.

Spouse's Consent

An election is a qualified election only if the participant's spouse consents to it. In addition to meeting other form, content, and procedure requirements, a spouse's consent to a participant's election must:

- Be in writing;
- Name a beneficiary that cannot be changed without the spouse's consent, or expressly consent to the participant's beneficiary designations (without further consent); and
- "Acknowledge" the effect of the participant's election.

Further, a consent has no effect unless "the spouse's consent is witnessed by a plan representative or a notary public[.]" Courts have held that there must be strict compliance with these requirements.

A spouse's guardian may sign the spouse's consent, even if the electing participant is the spouse's guardian.²⁶ However, a guardian must act in the best interests of his or her ward. A guardian serves under a

²⁶ Treas. Reg. Section 1.401(a)-20/Q&A-27.

court's supervision, and must account for his or her actions in court. Further, some guardianship decisions require a court's approval before the guardian implements the decision. It might be difficult to persuade a court that turning away money was in a surviving spouse's best interest. Although a participant might suggest making an irrevocable designation naming a trust for his or her spouse's benefit as the plan beneficiary, most retirement plans do not permit an irrevocable beneficiary designation.

A premarital agreement cannot serve as a spouse's consent. (See below.)

Notary or Plan Representative

ERISA does not define its use of the words "notary public" or "plan representative."²⁷ The Retirement Equity Act of 1984's legislative history does not explain what Congress meant.

A person might be a plan representative for the limited purpose of administering a plan's provisions required or permitted by ERISA's spouse's-consent rule if the plan administrator has authorized the person to witness a spouse's consent.

In a case that involved facts and forms typical of a retirement plan's service arrangements, a federal court found that the litigants who asserted that a spouse's consent had been witnessed did not offer enough evidence even to allege that a securities broker-dealer's employee was a plan representative.

Practice Pointer: If a CPA currently provides (or later might provide) services that require the CPA to be independent of the retirement plan or its administrator, the CPA should not witness a spouse's consent.²⁸

Many plan administrators assume that a person who may certify acknowledgments, affidavits, and other oaths under federal or state law is a notary.

If a person is not present in the United States, his or her acknowledgment may be made before a United States ambassador, consul, consular officer, or consular agent. A consular officer must officiate and perform a notarial act that an applicant properly requests. Likewise, federal law provides convenient ways for a person in military service to make an acknowledgment.

A notary must be independent of the participant. Although nothing in ERISA requires that a witness to a spouse's consent be independent of the electing participant, courts have interpreted the statute to include such a requirement. The federal courts' view is consistent with state laws concerning when a notary properly may officiate and the legal effect of a notary's certificate that he or she witnessed an acknowledgment.

Likewise, a plan representative must be independent of the participant. A federal court found that a plan administrator who was the same person as the electing participant could not, even if he was a plan representative (or even the only plan representative), witness his spouse's consent.

Practice Pointer: If a participant wants to make a beneficiary designation that would provide for anyone other than his or her spouse and the participant also is a plan administrator, trustee, or other fiduciary, suggest that the client ask the spouse to sign the consent in the presence of an independent notary.

Because ERISA permits a plan administrator to rely on a spouse's consent witnessed by a notary, it seems unlikely that a federal court would find that it could be prudent for a plan administrator to rely on a

²⁷ ERISA Sections 3, 205.

²⁸ American Institute of Certified Public Accountants, Principles of the Code of Professional Conduct Section 57 (2000).

spouse's consent witnessed only by the interested participant or someone who is subordinate to the interested participant.²⁹

Reliance on a Notary's Certificate

If a plan administrator acted according to ERISA's fiduciary duties when it decided whether to accept a spouse's consent, the consent, even if not properly witnessed, nonetheless discharges the plan from liability to the extent of the payments made before the plan administrator knew that the consent did not meet the plan's requirements.³⁰ If a plan administrator acted according to ERISA's fiduciary duties, it is not liable to the non-consenting spouse.³¹ Of course, the plan administrator must promptly correct or restrain payments once it knows that a spouse's consent was not properly witnessed.

If a plan might incur an expense because the plan administrator relied on a notary's certificate, the plan's fiduciary might be under a duty to evaluate whether it is in the plan's best interest to pursue a claim or lawsuit against the notary. A notary is responsible for damages caused by his or her negligent performance of his or her duties. Also, a spouse who did not receive what he or she would have been entitled to had the notary performed correctly may sue the notary.

Practice Pointer: Although generally accepted accounting principles sometimes require an accrual for a contingent liability, the accounting principle of conservatism often counsels against recording a contingent asset.³² One example is Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, paragraphs 91-97. Accounting Principles Board Statement (APB) No. 4, states "The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events[,] and minimization of the amount of net assets and net income." In paragraph 171, the Statement says, "[A]ccountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism[.]"). However, a gain contingency must be disclosed with a careful explanation.³³

Elective-Share Rights

In almost all states that do not provide community property, a decedent's surviving spouse may elect to take a share of the decedent's property, even if the decedent's will and other transfers had not provided for his or her spouse.

In many states, a surviving spouse's elective share is one-third of the decedent's estate. In a few, it is one-half.

²⁹ ERISA Sections 205(c)(6), 404(a)(1).

³⁰ ERISA Section 205(c)(6).

³¹ ERISA Section 404(a)(1).

³² Statement of Financial Accounting Standards No. 5, paragraph 17, published by the Financial Accounting Standards Board (FASB), 1975, states, "Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." See also, *Contingencies*, Accounting Research Bulletin No. 50, paragraphs 3 and 5. See generally, FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

³³ FASB Statement No. 5, *Accounting for Contingencies*, paragraph 17, published by the FASB, 1975, states, "Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization." See generally, FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, paragraph 97, published by FASB, 1980, states, "[T]he reliability of financial reporting may be enhanced by disclosing the nature and extent of the uncertainty surrounding events and transactions[.] . . . The aim must be to put the users of financial information in the best possible position to form their own opinion of the probable outcome of the events reported."

In Colorado, Hawaii, Kansas, Minnesota, North Dakota, South Dakota, Utah, and West Virginia, the elective-share percentage increases under a schedule based on the duration of the marriage. A typical schedule has an elective-share percentage that ranges from 3 percent for a marriage that lasted one year to 50 percent for a marriage of 15 years or more.

Some states compute an elective share only on probate property. But many states now provide that an elective share is computed on an "augmented estate" that includes several items of nonprobate property. Florida, New York, North Carolina, and Pennsylvania have detailed rules for counting this augmented estate.

Community Property

Community property is a term that lawyers use to refer to a regime that treats each item of property acquired by either spouse during a marriage and while both spouses are domiciled in a community-property state as owned equally by each spouse. Each spouse's ownership exists presently, notwithstanding that the other spouse currently holds title to or has control over the property. Generally, a retirement benefit is community property if contributions were made while the participant was married and domiciled in a community-property state.

In a separate-property regime, which normally applies in 41 states and all United States territories and possessions except Puerto Rico, an item of property normally belongs to the person who paid for it, earned it, or otherwise acquired it. Although property owned by a married person becomes subject to equitable distribution on a divorce or other marital dissolution, the property belongs completely to the person who owns it until a court makes an order that divides or distributes the property.

Community-Property States

Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Puerto Rico, Texas, Washington, and Wisconsin are the United States community-property states.

Alaska allows married people to choose a separate-property regime or a community-property regime. The separate-property regime applies unless the married couple agree to use a community-property regime. If the couple chooses community property, the spouses may use a written community-property agreement or trust to vary some of the state law provisions that otherwise would govern their community property.

Although community-property regimes in the USA are based primarily on the same general principle, community-property law varies considerably from state to state. (Wisconsin is the only state that has adopted any form of the *Uniform Marital Property Act*.) For example, if all plan contributions were made before the participant was married but investment earnings accrued after the marriage, some states would classify all the retirement benefit (including investment earnings) as separate property, while others might classify those investment earnings that accrued after the marriage as community property.

Community-Property Law and Retirement Plan Benefits

Whether a state's community-property law could affect a retirement benefit turns on whether the retirement plan is an ERISA plan or a non-ERISA plan.

ERISA

ERISA preempts state laws that relate to an ERISA plan. In particular, the U.S. Supreme Court has held that ERISA preempts community-property laws that otherwise might affect a retirement plan benefit. Instead, ERISA provides its own rules designed to protect a surviving spouse or to require a plan administrator to follow a QDRO that divides a participant's benefit to provide a benefit for the participant's spouse or former spouse.

State Law

Concerning an IRA or other non-ERISA plan, if a participant names a beneficiary other than his or her spouse for more than half of (or, more precisely, the participant's separate property plus community-property rights in) his or her retirement benefit, the spouse might have a right under state law to seek a court order invalidating the beneficiary designation, or at least as much of it as would leave the spouse with less than half of, or the spouse's community-property rights in, the benefit.

However, a payer may make distributions based on the beneficiary designation it has on record until it receives a court order restraining payment or at least a written notice that the spouse asserts his or her rights.

Marriage

As explained above, an important restraint on a beneficiary designation is a spouse's rights. Of course, these rights turn on a spouse showing that he or she was a participant's spouse. Although many people are accustomed to marriage certificates, sometimes it is unclear whether a marriage existed.

This part explains some basics of marriage, and then explains differences between ceremonial marriage and informal or common-law marriage.

The Nature of Marriage

Marriage is a civil contract and a relation or status by which each of two persons agrees to live with the other as spouses, to the exclusion of others.

States regulate marriage as part of their police power. Most states recognize a marriage contracted in another state, unless the marriage is contrary to an especially strong public policy.

Void Marriage

A void marriage is one that is invalid from its inception, and cannot be made valid.

A marriage is void if:

- The parties are too closely related, or
- Either party is (at the time of the ceremony or exchange of word) married to someone else.

In some states, a later marriage becomes valid on the end of an earlier marriage, if both parties to the later marriage were unaware that the earlier marriage was undissolved when they entered into the later marriage.

A marriage is void if the parties are of the same sex and a restriction against such a marriage is not unconstitutional.

Either party may "walk away" from a void marriage without waiting for a divorce or annulment.

Voidable Marriage

A voidable marriage is one that is initially invalid but remains in effect unless ended by a court order. For example, a marriage might be voidable if either party was underage, drunk, or otherwise legally incompetent. Likewise, a marriage is voidable if one party used fraud, duress, or force to induce the other party to "agree"

to the marriage. The parties may ratify an otherwise voidable marriage by words or conduct after the removal of the impediment that made the marriage voidable.

Ceremonial Marriage

A ceremonial marriage is a marriage performed according to a state statute. Most people prefer a ceremonial marriage to an informal or common-law marriage because a ceremonial marriage is easier to prove.

A license to marry is required, and is furnished by a state court or official upon approval of an application designed to check the parties' eligibility to marry. In most states, an application must state identifying information, information about each prior marriage of either applicant, that neither of the applicants is afflicted with a communicable disease, and other facts necessary to find whether there is a legal impediment to the proposed marriage. A refusal to issue a marriage license is reviewable by a court. An application for a marriage license is a public record.

Most states require at least a guardian's approval and sometimes a court's approval if either party is a minor or mentally incapacitated.

Most states provide that a judge, government official, or clergyman may perform a ceremony. Some people use the term *civil marriage* to describe a ceremony led by a judge or government official, as distinguished from one solemnized by a clergyman. Some states permit the parties to perform their marriage ceremony. Some states permit and others prohibit a proxy marriage, a ceremony in which someone stands in for an absent party.

A failure to comply with statutory rules does not necessarily result in a void marriage. Sometimes a defect makes a marriage voidable rather than void. In a state that permits common-law marriage, a defective ceremonial marriage often results in a valid common-law marriage.

A person who wants to prove that a marriage exists (or existed until the other person's death) may refer to the marriage certificate as evidence of the marriage's validity. Unless someone else shows persuasive evidence of a defect, a marriage certificate usually is strong evidence that the marriage occurred.

Same-Sex Marriage

Currently, a few states recognize a marriage between two persons of the same sex.

Massachusetts law provides that same-sex couples may marry, just as opposite-sex couples may.

The laws of California, Connecticut, New Jersey, and Vermont provides that a same-sex couple may choose the protections and duties of marriage. Although the statutes call a same-sex marriage a civil union or domestic partnership, the protections and duties provided are those of marriage.

Because of potential differences between federal law (which would not recognize a same-sex couple as spouses if the federal statute that so provides is not unconstitutional) and state laws, a couple might be spouses for state-law purposes and not spouses for federal-law purposes.

Common-Law Marriage

A common-law marriage (perhaps more appropriately called an informal marriage) is a marriage that was not performed by a licensed ceremony, but was created by the simple agreement of the parties.

Each party to such a marriage must:

- Be legally capable of making a marriage contract.
- State his or her present agreement to the marriage (or to the relation of spouses).
- Agree to live with his or her spouse to the exclusion of all others.

Although some people mistakenly assume that a period of cohabitation results in a common-law marriage, this is not true under any state's law. Conversely, no period of cohabitation is necessary; the present agreement to the marriage is all that is needed.

If the law of a state that recognizes common-law marriage applies, a couple might be married without any ceremony or writing. Even an implication of consent to a marriage might be sufficient. Also, a marriage ceremony that had a defect is likely to result in a common-law marriage.

Usually, the absence of a ceremony (and the absence of witnesses, other than the parties) makes it difficult to prove that a common-law marriage exists or existed. Often, there is an evidence-law rule or presumption against the claimant testifying to the creation of the relationship. Courts consider evidence of how each person described the relationship to third persons, and how third persons understood the relationship. Either spouse's denial of the marriage in records such as a driver's license, Social Security claims, tax returns, insurance applications, bank accounts, and wage records does not necessarily deny a common-law marriage. The burden of proving a common-law marriage is on the person who asserts that it exists or existed.

Practice Pointer: If a client wants help in evaluating a claim of a common-law marriage, a CPA should refer such a client to an expert lawyer.

Recognizing Common-Law Marriage

As of January 2007, Alabama, Colorado, the District of Columbia, Iowa, Kansas, Montana, New Hampshire (for survivorship only), Oklahoma, Rhode Island, South Carolina, Texas, and Utah recognize a common-law marriage made in its state now. But many other states repealed common-law marriages not long ago, and persons living now might have married before a state's repeal.

All states recognize a marriage that, even if it does not meet all requirements of local law, was valid under the laws of the state in which the spouses were present when they contracted the marriage. Likewise, states recognize a marriage made according to any Native American Indian law or custom. Further, some states that recognize common-law marriage internally recognize a marriage that the spouses entered into while they lived in another state, notwithstanding that the marriage was invalid in the other state.

***Caution:** Because of the recognition that states give to the laws of other states and other nations, it is possible for a common-law marriage to exist anywhere in the USA. Although the states that recognize informal marriage are the minority, Americans' mobility enables informal marriages. Even a weekend trip across state lines could result in a marriage. Further, among those states that currently do not recognize common-law marriage, almost half allowed common-law marriage at a time when people still living now might have married.*

Common-Law Marriage and Retirement Benefits

How a common-law marriage might affect a retirement benefit turns on whether the benefit is provided under an ERISA plan or a non-ERISA plan.

ERISA

An ERISA plan usually provides (and must provide) that some or all of a plan benefit belongs to a spouse. If the law of a state that recognizes common-law marriage applies, a couple might be married without any ceremony or writing. A recognized common-law marriage is no less a marriage than is a ceremonial marriage.

Example. Gary and Zoe lived together in Alabama. Gary never made any beneficiary designation under his employer's ERISA-governed retirement plan. The plan provides that a surviving spouse is entitled to 100 percent of the participant's account. When Zoe calls Gary's former employer to ask about the plan benefit, the

employer tells her that it has no record that Zoe is Gary's spouse. Zoe files the plan's claim form and attaches to it an affidavit that states facts that, if correct, would prove a common-law marriage under Alabama law. Because the employer, acting as plan administrator, does not receive any contrary information (after inviting Gary's personal representative to furnish relevant information), it decides that Zoe is Gary's surviving spouse. The plan administrator instructs the custodian to pay the full benefit as Zoe requested.

Practice Pointer: A plan administrator must act as a prudent expert when deciding plan claims. Therefore, a plan administrator should get an expert lawyer's advice when evaluating any person's claim that he or she is the common-law spouse of a participant.

State Law

If a participant in a non-ERISA plan has a spouse, state law (or a Native American Indian tribe's law) may provide that some or all of the participant's plan benefit belongs to the spouse (as previously explained). If the law of a state that recognizes common-law marriage applies, a couple might be married without any ceremony or writing, and the common-law spouse will enjoy whatever rights the state affords a spouse.

Although a payer is protected in making a payment according to the beneficiary designation under a non-ERISA plan, a distributee of a benefit paid under the plan receives any payment subject to the rights of the spouse (including a common-law spouse).

Example. Hubert and Wilma lived in Kansas throughout their working lives. In early 1993, before Hubert met Wilma, Hubert named his brother, Bob, as the beneficiary under Hubert's IRA. Even after his marriage to Wilma in late 1993 and the birth of their children, Debbie in 1994 and Seth in 1996, Hubert did not change his beneficiary designation. After Hubert's retirement, Hubert and Wilma moved to New York. Hubert died without having made any will. After Hubert died, Bob sent in a claim to the IRA custodian, which paid Bob all of Hubert's retirement plan balance. On his death, Hubert's IRA balance was \$200,000 and his probate assets were \$60,000. There was nothing else.

For ease of illustration, both parts of this example omit family exemption, homestead allowance, funeral and administration expenses, debts, taxes of all kinds, and lawyers' fees.

If Wilma does not take an elective share of Hubert's augmented estate, Hubert's estate will be divided as follows:

Wilma	0	\$55,000	\$ 55,000	21%
Debbie	0	2,500	2,500	1%
Seth	0	2,500	2,500	1%
Bob	\$200,000	0	200,000	77%
Total	\$200,000	\$60,000	\$260,000	100%

If Wilma takes an elective share of Hubert's augmented estate, Hubert's estate will be divided as follows:

	Augmented Estate	Share
Wilma	\$ 86,666.67	33.33%
Debbie	0	
Seth	0	
Bob	<u>\$173,333.33</u>	<u>66.67%</u>
Total	\$260,000.00	100.00%

Because Hubert's probate estate is insufficient to pay Wilma the amount to which she is entitled, Bob must pay Wilma \$26,666.67 (\$86,666.67– \$60,000).

Dower or curtesy (which applies only in Arkansas, the District of Columbia, Kentucky, Ohio, and West Virginia) might provide a surviving spouse lifetime rights to the decedent's land (but not to personal property, such as retirement benefits).

Same-Sex Marriage

Only California, Connecticut, Massachusetts, New Jersey, and Vermont expressly provide full same-sex marriage. Every other state refuses, whether lawfully or unlawfully, a full marriage license to a same-sex couple. Nonetheless, a same-sex couple might marry in a state that permits common-law marriage. Notwithstanding statutes that try to restrict marriage to opposite-sex couples, a same-sex marriage might be a valid marriage if those statutes are unconstitutional.

Also, a state might recognize a marriage made in another nation that provides same-sex marriage.

If same-sex couples are spouses under state law and the United States Code's general provision that same-sex couples are not spouses for any federal statute is unconstitutional, ERISA applies to a participant, his or her spouse, and their property rights as it applies for an opposite-sex couple.

If a same-sex couple reside in a state other than the state in which they married, a federal statute says that the current state need not recognize the marriage established in the other State.

"No State shall be required to give effect to any public act, record, or judicial proceeding of any other State respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State, or a right or claim arising from such relationship."³⁴ It is unclear whether this statute is the law, because it might be unconstitutional.³⁵

Practice Pointer: If a personal financial planning client is a member of a same-sex couple, and wants to name a beneficiary other than his or her spouse, a CPA should urge the client to get an expert lawyer's advice.

Unusual Marriages

Other nations recognize marriages and other relationships that do not fit neatly into the English and American construct of marriage.

³⁴ 28 U.S.C. Section 1738C.

³⁵ See U.S. Constitution, article IV, section 1, and the Fifth Amendment.

Most Americans assume that it is impossible for a person to have two legitimate spouses at the same time. That is not necessarily so if a person entered into a marriage in another nation. Although a U.S. state might choose not to recognize a marriage that it finds contrary to its strong public policy, a state may give deference to the customs and laws of another nation. At least one state court has held that a decedent can have more than one spouse for inheritance purposes.

However, a court may find that a relationship that is recognized under another nation's law or custom is not the same kind of relationship that the U.S. state recognizes as a marriage. For example, a Florida court held that a "Union Marital de Hecho" (a marital union in fact) under Colombian law was not the equivalent of a common-law marriage. Likewise, a state will not recognize concubinage as a marriage.

Using Agreements to Change a Spouse's Rights

A couple who are about to marry, or who already are married, may agree to change some of the property rights that come from marriage.

Premarital Agreements

A premarital agreement (sometimes called a *prenuptial* or *antenuptial* agreement) is an agreement made between two persons who are about to marry concerning property rights that arise from marriage. Typically, a premarital agreement provides that one or both of the soon-to-be spouses waive one or more of the property rights that a spouse would otherwise have. Within limits required by public policy and basic fairness, a premarital agreement may specify what property division will apply if the marriage ends by divorce or when it ends by death. A premarital agreement may waive a spouse's right to a share of the other's estate.

Under the *Uniform Premarital Agreement Act*, the parties to a premarital agreement may contract concerning property rights, the support of a spouse or former spouse, making a will or trust, and "[t]he ownership rights in and disposition of the death benefit from a life insurance policy."

Usually, a premarital agreement must be written. In most states, a premarital agreement must be in a writing signed by the parties. In New York, a premarital agreement must be signed and sworn by each of the parties in the presence of a notary public or similar officer.

Many state statutes or court decisions impose additional requirements. Typically, each party should fully disclose his or her financial circumstances to the other. In some states, a person need not disclose an asset that was not subject to his or her control. Further, the better practice is for each party to get the advice of a lawyer of his or her choosing. In those states that do not regulate premarital agreements by statute, courts apply ordinary contract-law principles, but with extra scrutiny in recognition of the confidential relationship of those engaged to marry.

A court will enforce a premarital agreement that makes reasonable provision for the surviving spouse even in the absence of full and fair disclosure. A court will enforce an unreasonable agreement only if there was full and fair disclosure. A court will not enforce an agreement to the extent that doing so would cause a spouse to become eligible for public assistance.

In some circumstances, it might be difficult to enforce the terms of a premarital agreement. At least one court has held that an offset against contract rights in recognition of a surviving spouse's receipt of retirement benefits (which were not provided by the premarital agreement) could be an ERISA violation, notwithstanding that the person applying the offset had no connection to any ERISA plan. According to the court, that was the case because the offset had the effect of "discriminating" against the spouse because she exercised her right to a benefit under an ERISA plan.

Using a Premarital Agreement to Waive a Spouse's Right to a Retirement Benefit

The effect (if any) of a premarital agreement concerning a retirement benefit turns on whether the benefit is provided by an ERISA plan or a non-ERISA plan.

ERISA

A premarital agreement cannot waive a spouse's right to an ERISA plan benefit.

A premarital agreement rarely states all the form requirements necessary to state a valid spouse's consent to waive rights under an ERISA retirement plan.

A spouse's consent to a participant's qualified election must be signed by the spouse, and a person making a premarital agreement is not yet the spouse.

The IRS has stated its interpretation that a premarital agreement may not constitute a waiver of spouse's-consent rights.

All of the federal court decisions on this question have held that a premarital agreement cannot be used to waive a spouse's rights.

State Law

Even if a surviving spouse is entitled to an elective share, community property, or other protective rights under state law, an expertly prepared premarital agreement should be sufficient to eliminate or waive a spouse's right to a benefit under an IRA or other non-ERISA plan.

Marital Agreements

A marital agreement is an agreement made between two persons, who already are spouses, concerning property rights that arise from their marriage. Typically, a marital agreement provides that one (or both) of the spouses waives one or more of the property rights that a spouse would otherwise have. A marital agreement may waive one spouse's right to a share of the other's estate. Within limits required by public policy and basic fairness, a marital agreement may specify what property division will apply if the marriage ends in divorce or when it ends by death.

Usually, a marital agreement must be written. In most states, a marital agreement must be in a writing signed by the parties. In New York, a marital agreement must be signed and sworn by each of the parties in the presence of a notary public or similar officer.

Many state statutes or court decisions impose additional requirements meant to ensure basic fairness. Typically, each party should fully disclose his or her financial circumstances to the other. Further, the better practice is for each party to obtain the advice of a lawyer of his or her choosing. Some states require that the marital agreement be fair and equitable.

A marital agreement is void if it was signed under a threat of a divorce.

Using a Marital Agreement to Waive a Spouse's Right to a Retirement Benefit

The effect (if any) of a marital agreement concerning a retirement benefit turns on whether the benefit is provided by an ERISA plan or a non-ERISA plan.

ERISA

A marital agreement may waive a spouse's right to a benefit under an ERISA plan if the agreement states the spouse's consent to a qualified election in a way that meet ERISA's and the plan's provisions. To do so, a

marital agreement must state all form requirements necessary to state a valid spouse's consent.³⁶ To accomplish that, a family lawyer should consult an expert employee-benefits lawyer and the plan administrator.

Practice Pointer: If a client asks for information about how to state a spouse's consent, a CPA might suggest that the client get the retirement plan's forms.

State Law

A marital agreement may waive a spouse's right to a benefit under a non-ERISA retirement plan.

Even if a surviving spouse is entitled to an elective share, community property, or other protective rights under state law, an expertly prepared marital agreement should be sufficient to waive a spouse's right to a benefit under a non-ERISA retirement plan.

Charitable Gifts

A participant may name a charity as a beneficiary.

Practice Pointer: For a person who already has decided to make charitable gifts on death and expects his or her estate to be subject to a significant federal estate tax, some financial planners suggest that using a retirement plan benefit might be an efficient way to provide the gift. They suggest this because deferred compensation is subject to both federal income tax and federal estate tax, while a capital asset enjoys a "stepped-up" basis (except for deaths in 2010) and is not subject to income tax until the beneficiary sells the asset. Other planners point out that the federal income tax deduction for federal estate tax attributable to property that is income in respect of a decedent partially mitigates the double tax.³⁷ Along with this, they argue that a retirement plan might permit longer income tax deferral while postdeath income on capital assets will subject the beneficiary to income tax. Considering which course might be "right" turns on the donor's and the planner's assumptions. Further, non-tax factors might favor a particular approach.

Although a retirement benefit will be included in a participant's taxable estate for federal estate tax purposes, his or her estate will have a deduction for the amount that properly passes to charity.³⁸ Further, although a distribution from a retirement plan is included in income for federal income tax purposes, a charity does not pay federal income tax on its receipts from charitable gifts.³⁹

Death

A death benefit under a retirement plan turns on proving that a participant's death occurred. In some cases, it might matter when a death occurred. The following sections address the circumstances of simultaneous deaths and presumed deaths.

³⁶ ERISA Section 205.

³⁷ See IRC Section 691(c).

³⁸ IRC Section 2055.

³⁹ IRC Section 501(a).

Simultaneous Deaths

Some possible circumstances of simultaneous death are addressed in the following:

Participant and a Beneficiary

For some retirement plans, the order in which a participant and his or her beneficiary die is irrelevant. Under some plans, a person cannot be a beneficiary if that person is not living when a benefit becomes distributable.

ERISA

If an ERISA plan's administrator must decide the order of deaths between a participant and a beneficiary, and the plan does not provide a presumption concerning the order of deaths, it might be prudent for a plan administrator to follow a *Uniform Simultaneous Death Act* or the *Uniform Probate Code*.

State Law

The 1940 *Uniform Simultaneous Death Act*, adopted by many states, provides that if "there is no sufficient evidence that the persons have died otherwise than simultaneously, the property of each person shall be disposed of as if he [or she] had survived [the other person]." The *Uniform Probate Code* provides that a person may not qualify as an heir unless he or she survived the first decedent for 120 hours. Further, the person who would claim through the heir has the burden of proving the duration that the heir survived the first decedent. The 1991 version of the *Uniform Simultaneous Death Act* has almost the same rule. A payer that decides claims under a non-ERISA plan might need to follow state law.

Caution: A retirement plan's documents may vary the rules for deciding the order of deaths.

A common-disaster clause or a delay clause of up to six months does not disqualify property for the federal estate tax marital deduction.

Between or Among Potential Beneficiaries

ERISA

If an ERISA plan's administrator must decide the order of deaths between or among potential beneficiaries and the plan does not provide a presumption concerning the order of deaths, it might be prudent for a plan administrator to indulge a presumption that all persons who died within a few days of one another died at the same time and survived to the relevant time.

State Law

A plan administrator that decides claims under a non-ERISA plan might need to follow state law. Moreover, a bank, insurer, or broker-dealer that decides claims concerning an IRA or other non-ERISA plan might be required to follow state law, including banking, insurance, and securities laws.

Practice Pointer: For tax-planning purposes, a wealthy person might prefer to vary the "default" rules that apply to simultaneous deaths by express language in his or her beneficiary designation. Some plans follow such a provision in a beneficiary designation; other plans do not.

Presuming the Death of an Absentee

ERISA

An ERISA plan's administrator need not follow state law, and instead may make its own rules and use discretion in deciding whether or when a person's death occurred.

State Law

In ordinary circumstances, a plan administrator or payer should not presume a person's death. Instead, a plan administrator or payer should require the claimant (usually, the next beneficiary) to prove the absentee's death by a court order.

Under the common law, a person was presumed dead if he or she had been absent for a continuous period of seven years. Likewise, an absentee's exposure to a specific peril was a sufficient ground for presuming death. Further, death may be inferred if survival of the absentee would be beyond human expectation or experience. Courts sometimes required considerable evidence of an unexplained absence. For example, a person's absence from the places where his relatives resided along with his failure to communicate with his relatives was not enough to show that he was absent from his residence without explanation.

In 1939, the *Uniform Absence as Evidence of Death and Absentees Property Act* reversed the common-law rules that a person being absent for seven years (or any duration) or being exposed to a specific peril did not set up a presumption of death. Instead, these facts are merely evidence for a court or jury to consider in making its own decision on whether the absentee's death had occurred.

The *Uniform Probate Code*, portions of which many states have adopted, returns to a presumption. A person is presumed dead after he or she has been absent for a continuous period of years, which varies by state from three to seven years. However, someone who seeks a declaration of an absentee's death must prove to a court's satisfaction that the absentee was not heard from after diligent search or inquiry, and that the absentee's absence is not satisfactorily explained.

Usually, the person who would benefit from the absentee's death bears the burden of proof.

Also, unless sufficient evidence proves that death occurred sooner, the end of the absence period is deemed the date of death.

Caution: *The presumption of an absentee's death does not apply to all property in the same way. Some states do not use the presumption to provide a life insurance or annuity death benefit.*

The terrorist attacks of September 11, 2001 and hurricanes in 2005 focused renewed attention on laws that permit a finding of death based on exposure to a specific peril.

Disclaimer

A disclaimer (also called a *renunciation* in some states) is a writing in which a beneficiary says that he or she does not want to receive a benefit. To be legally effective and, if desired, to achieve tax-planning purposes, the disclaimer must carefully state certain conditions. (See the following.)

A retirement plan generally will not permit a participant to disclaim his or her benefit, because a plan typically provides that a participant cannot assign or give away any right he or she has under the plan.⁴⁰ But a retirement plan might permit a beneficiary's disclaimer.⁴¹ A plan administrator may (but need not) accept a beneficiary's disclaimer.

If a beneficiary makes a valid disclaimer, the benefit will be distributable as though the beneficiary had died before the participant's death.

⁴⁰ ERISA Section 206(d), IRC Section 401(a)(13).

⁴¹ See General Counsel Memorandum (GCM) 39858 (September 9, 1991). See also Ltr. Ruls. 9226058 (Mar. 31, 1992), 9037048 (Jun. 20, 1990), 8922036 (Mar. 2, 1989).

Although people don't lightly turn away money, sometimes there is a good reason for a beneficiary to make a disclaimer. A typical reason is to complete tax-oriented estate planning. If a beneficiary makes a valid disclaimer that also meets all requirements of Internal Revenue Code (IRC or the Code) Section 2518, the disclaimed benefit will not be in the disclaimant's estate for federal estate tax purposes.⁴² Many states have a similar rule for state death tax purposes, but some apply further restrictions. A surviving spouse, executor, or trustee might use a disclaimer to reduce the amount of property that becomes the subject of the federal estate tax marital deduction.

A frequent use of a disclaimer is to correct a "wrong" beneficiary designation.

Example. Larry has saved for retirement through his employer's retirement plan. When he enrolled in the plan, he was single, and he named his older sister, Carol, as beneficiary. Recently, Larry was married to Marie. Shortly after returning from their honeymoon, Larry was killed in a traffic accident. Carol believes that if Larry had thought about it, he would have wanted his wife to be his beneficiary. Therefore, Carol files a disclaimer with the plan administrator. Although Carol cannot directly control who gets the benefit, her lawyer advised her that the plan's "default" provision (explained earlier), together with the state's intestacy law, will result in Marie's receiving the benefit. Carol feels that is a morally sound result and what Larry would have wanted. The use of a disclaimer allows the family to achieve a good result.

Practice Pointer: A qualified disclaimer—if it is a disclaimer of all of a would-be beneficiary's benefit—could change the designated beneficiary for the purposes of a retirement plan's minimum-distribution provision.

Caution: A beneficiary should not make a disclaimer without first getting a lawyer's advice that doing so will not be a federal healthcare crime.

Disclaimer by an Agent

If a retirement plan (other than an IRA) permits a beneficiary to disclaim a plan benefit, whether that power may be exercised only by the beneficiary personally or by the beneficiary's executor, personal representative, guardian, or agent as a fiduciary depends on the plan's language. Unless the plan states that a power to disclaim may be exercised by such a person, only the beneficiary personally may exercise the power to disclaim.

For an IRA that does not state whether an agent may disclaim a right under the IRA, it is unclear whether a similar result would apply under state law. In some states, a personal representative may disclaim an interest and the disclaimer relates back to the disclaimant's death or even to the death of the person making the disclaimant a beneficiary.

Tax-Valid Disclaimer

To be effective for federal tax purposes, a disclaimer must meet the following conditions:

- The disclaimer must be made before the would-be beneficiary accepts or uses any benefit.
- The benefit must pass without any direction by the disclaimant.
- The disclaimer must be in writing and must be signed by the disclaimant.
- The writing must state an irrevocable and unqualified refusal to accept the benefit.

⁴² IRC Section 2518.

- The writing must be delivered to the plan administrator.
- The writing must be so delivered no later than nine months after the date of the participant's death or the date the beneficiary attains age 21 (whichever is later).
- The disclaimer must meet all requirements of applicable state law.⁴³

State law may impose further conditions. For example, in some states, a disclaimer must state the disclaimant's belief that he or she has no creditor that could be disadvantaged by the disclaimer. In some situations, especially when the beneficiary is a minor child or an incapacitated person, a disclaimer requires court approval. Even when court approval is not required, state law may require that a disclaimer is not valid unless filed in the appropriate probate court.

Practice Pointer: In most states, (unless the drafter is admitted to practice law) drafting a document that could affect a person's right is the unlawful practice of law. Even selecting a form published by the government might be the unlawful practice of law. Because the unlawful practice of law is a crime, it is also likely "an act discreditable to the profession."⁴⁴ Even if a CPA does not suffer criminal prosecution or professional discipline, a CPA's malpractice insurance contract would not cover the practice of law.

Beyond state law and tax-law conditions, a plan might impose further requirements.

Government Claims

Medicaid

A retirement plan benefit probably is counted as an "available resource" for Medicaid eligibility purposes to the extent that the patient, or his or her spouse, currently has a legal right to receive payment under a plan.⁴⁵

Practice Pointer: Suggest that a client consider not selecting as his or her beneficiary a person likely to need Medicaid benefits if he or she could make a more appropriate beneficiary designation.

Caution: *A beneficiary should not make a disclaimer without first getting assurance from a lawyer that doing so will not be a federal healthcare crime.*

After using the "community-spouse-resource allowance," a participant's retirement plan benefit probably is counted as an "available resource" for his or her spouse's Medicaid eligibility to the extent that the participant currently has a legal right to receive payment under a plan.

IRS Levy

Although ERISA's antialienation rule reflects a policy that a participant's retirement benefits should not be available to ordinary creditors, a U.S. tax lien or levy applies to ERISA plan amounts.⁴⁶ A U.S. tax lien or levy

⁴³ IRC Section 2518; GCM 39858 (September 9, 1991).

⁴⁴ See American Institute of Certified Public Accountants, Code of Professional Conduct, Rule 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.01), and accompanying Interpretations.

⁴⁵ See 42 U.S.C. Sections 1396a–1396p.

⁴⁶ ERISA Section 514(d); IRC Section 6334(c); Treas. Reg. Section 1.401(a)-13(b)(2).

also supersedes any anti-alienation provisions of a non-ERISA plan. But a levy extends only to property rights that exist at the time of the levy.⁴⁷

If a participant has not yet severed from employment or reached age 59½, the IRS usually will not levy the participant's retirement plan benefit (other than an IRA). The IRS will levy a participant's retirement benefit only if he or she has been unusually abusive. A levy on retirement savings requires the approval of an IRS supervisor.⁴⁸

Unclaimed Property

ERISA

A state's unclaimed property law does not apply to an ERISA plan.⁴⁹

Because a state's unclaimed property law would, if applied, require delivery of plan assets and liabilities, such a law relates to the plan and its administration and thus ERISA preempts it. The Department of Labor (DOL) has consistently advised that ERISA preempts state abandoned-property laws.⁵⁰ Likewise, the Secretary of Labor has taken that position as a friend of the court.

State Law

Each of the 50 states (and the District of Columbia and U.S. possessions) has a law regulating abandoned or unclaimed property. For instance, the *Uniform Disposition of Unclaimed Property Act*, some form of which most states adopted, requires a person in possession of intangible property that is unclaimed by its owner for a period of years (which varies by state and kind of property) to transfer that property to the state's custody.

Under most states' laws, an amount, property, or right under a non-ERISA retirement plan is not payable or distributable to measure a presumed abandonment period "unless, under the terms of the account or plan, distribution of all or part of the [money or property] would then be mandatory." Under many plans, a distribution is not required until the April 1 that follows the later of the participant's age 70½ or retirement. It is unclear how, if at all, this rule applies to an IRA. An IRA insurer or custodian ordinarily does not know whether a distribution is required because the owner or beneficiary might have taken his or her required distribution from another IRA.

Following such a required beginning date, a retirement plan account or benefit is presumed abandoned unless the distributee made contributions, accepted payment, or communicated about the account or benefit before the end of the abandonment period.

Tax-Oriented Estate Planning

Retirement Benefit Included in Federal Estate

With limited exceptions, the value of a participant's retirement benefits as of the date of his or her death is included in the participant's estate for federal estate tax purposes.⁵¹ Or if payments have begun, the value of the remaining payments (if any) is included in the participant's estate for federal estate tax purposes.

⁴⁷ Treas. Reg. Section 301.6331-1(a); see also ILM 200102021 (Oct. 5, 2000, rel. Jan 12, 2001).

⁴⁸ IRM paragraph 5.11.6.2.

⁴⁹ ERISA Sections 403(c)(1), 514(a).

⁵⁰ DOL ERISA Advisory Opinions 78-32A (Dec. 22, 1978), 79-30A (May 14, 1979), 83-39A (Jul. 29, 1983), 94-14A (Dec. 7, 1994).

⁵¹ IRC Sections 2033-2039.

Federal Estate Tax

The federal estate tax is a tax on the right to transfer property on death.⁵² The tax is imposed on a decedent's taxable estate, which includes nonprobate property and rights. An unlimited marital deduction allows a person to transfer any amount to his or her surviving spouse without federal estate tax at that time, but tax may apply when the survivor dies.⁵³ A tax credit allows a person to transfer about \$1 million or more (as shown below) without federal estate tax.⁵⁴

Federal Estate Tax "Exemption"

Although the provision that "exempts" most estates from the federal estate tax really is a credit, many people express it as an approximately equivalent "exclusion" amount.⁵⁵

Exclusion Amount for Federal Estate Tax	
For Estates of Decedents Dying During	Exclusion Amount
2002	\$1 million
2003	\$1 million
2004	\$1.5 million
2005	\$1.5 million
2006	\$2 million
2007	\$2 million
2008	\$2 million
2009	\$3.5 million
2010	No federal estate tax
2011	\$1 million

If all the unified credit against federal estate and gift taxes remains available and an estate's executor elects to use it, an estate may in effect exclude up to about the amount shown in the table above. For estates of decedents dying during 2010, there is no federal estate tax, but the federal gift tax generally applies on a gift other than a gift within the annual \$12,000 (for 2007) exclusion. For 2011 and later years, the federal tax law in effect before June 7, 2001 applies.

⁵² IRC Section 2001.

⁵³ IRC Section 2056.

⁵⁴ IRC Section 2010(b).

⁵⁵ In one sentence that includes three subjunctives and conditions, IRC Section 2010(c) provides that "the applicable credit amount is the amount of the tentative tax which [sic] would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the applicable exclusion amount[.]"

Practice Pointer: Many people have more wealth (at least for tax purposes) than they think. For estate tax purposes, a taxable estate includes nonprobate property, such as the following:

- A home
- Personally owned life insurance benefits
- Employment-based life insurance benefits
- Retirement benefits.

Example. Because Harry and Sally have young children and it takes both of their paychecks to run the household, they hold a term life insurance contract on the life of each parent; each death benefit is \$1 million. They own their house, which is worth \$200,000. Harry's retirement plan accounts add up to \$900,000. (Although Harry does not consider himself wealthy, his estate for federal estate tax purposes is at least \$2 million.) If either Harry or Sally dies, there will be no federal estate tax as long as all property passes to the surviving spouse. But if the second spouse dies during 2007, there will be a federal estate tax (assuming no deductions or credits), as much as about \$780,800 of which could have been avoided if Harry and Sally had planned gifts or trusts that would transfer some property or rights to their children before or on the death of the first parent to die.

Federal Estate Tax Marital Deduction

A retirement plan participant may provide for his or her spouse in a way that gets the federal estate tax marital deduction.

A beneficiary designation of a participant's spouse qualifies for the marital deduction as long as the spouse is the only person who can benefit, at least until his or her death.⁵⁶

A survivor annuity for the spouse qualifies for the marital deduction as long as the spouse is the only person who can benefit under the survivor annuity, at least until his or her death, the annuity qualifies for the marital deduction.⁵⁷

A beneficiary designation of a qualified terminable interest property (QTIP) trust qualifies for the marital deduction.

Qualified Terminable Interest Property Trust

If a trust agreement includes the necessary provisions and the executor and the trustee properly make the election, a (QTIP) trust qualifies for the marital deduction.

Practice Pointer: If a client is preparing a QTIP trust, remind the client's estate planning lawyer that a retirement plan does not state provisions for distinguishing between income and principal. Therefore, a QTIP trust must provide for its trustee to decide income as a percentage of the QTIP trust's assets or based on the information available to the trustee. That information might be quite limited because ordinarily a retirement plan's trustee has no reason to keep records of whether a tax-exempt plan trust's investment changes reflect realized or unrealized capital gains, capital-gain distributions, dividends, interest, or other kinds of income.

⁵⁶ IRC Section 2056. See Let. Rul. 199936052 (June 16, 1999).

⁵⁷ IRC Section 2056.

Caution: A surviving spouse who does not exercise his or her right to take all of the income from a retirement plan benefit, and thereby the QTIP trust's income, should consider whether his or her waiver or non-exercise of that right is a taxable gift of a future interest.

Practice Pointer: A careful drafter of a QTIP trust might consider provisions that would preclude (or at least not authorize) an excessive trustee fee. If a trustee is a family member who is a natural object of the QTIP trust beneficiary's bounty, an excessive trustee fee is a taxable gift from the surviving spouse to the trustee.⁵⁸ In addition to gift tax on the portion of the trustee's fee that is in excess of reasonable compensation, a surviving spouse's acquiescence in an excessive fee might call into question whether the surviving spouse truly had a right to all of the trust's income and, thereby, whether the trust is or was a QTIP trust.⁵⁹

A participant might want to use a QTIP trust when he or she wants to use the federal estate tax marital deduction but does not want his or her spouse to receive a retirement plan benefit directly.

Example. Charles and Ellen, a married couple, have no children together, but Charles has children from a previous marriage. A QTIP trust can allow Charles to provide for Ellen during Ellen's life, while preserving some of the benefit for Charles's children.

Example. Beth cares very much for her husband, Ken, and wants her retirement plan benefit to provide for him if she dies first. But Beth believes that Ken is irresponsible when it comes to handling money and prefers that a professional trustee manage his financial needs. A QTIP trust could allow Beth to provide for Ken without putting all the money in his hands.

Qualified Domestic Trust for an Alien

Normally, an unlimited marital deduction is available for property passing to a decedent's surviving spouse. The deduction may apply to all or a portion of a retirement plan benefit to the extent that the decedent's surviving spouse is entitled to the benefit or the benefit is payable into a QTIP trust for the spouse's benefit. But if a person's spouse is an alien, the marital deduction is restricted, even if the alien spouse resides in the United States.⁶⁰

The federal estate tax marital deduction is available for a transfer to an alien spouse only if the property passing to the spouse is provided through a qualified domestic trust (QDOT).⁶¹

A QDOT is a trust that holds assets for the benefit of (but not subject to the control of) the spouse during the spouse's life. The trust must restrict distributions during the spouse's life to trust income and hardship distributions, or else pay a special tax on any other distribution.⁶² A QDOT must have at least one trustee who is a U.S. citizen, or a U.S. corporation must be responsible to pay any federal estate tax due from the trust.⁶³ There are many further technical conditions specified by the Treasury regulations.⁶⁴

⁵⁸ TAM 200014004 (Dec. 10, 1999).

⁵⁹ IRC Section 2056(b)(7).

⁶⁰ IRC Sections 2056, 2056A.

⁶¹ IRC Section 2056(d)(2).

⁶² IRC Section 2056A(b).

⁶³ IRC Section 2056A.

⁶⁴ Treas. Reg. Sections 20.2056A-1 through 20.2056A-13.

Practice Pointer: Designing a trust to get QDOT tax treatment involves an expert tax lawyer's advice. Do not suggest a general practitioner for this.

It is unlikely that a retirement plan will, by its own terms, meet the conditions for a surviving spouse's benefit to be treated as a QDOT. Therefore, a participant who wants QDOT treatment for his or her spouse's benefit should, with the advice of an estate planning lawyer, choose a qualifying trustee and create a QDOT. The trustee and the surviving spouse must be careful to follow any further requirements particular to QDOT treatment for a retirement plan.⁶⁵

Practice Pointer: To cause any retirement plan benefit remaining on the participant's death to pass into the QDOT, the participant should change his or her beneficiary designation.

To preserve the marital deduction for a benefit passing to an alien spouse, the spouse must "transfer" his or her retirement plan distribution to a QDOT before the decedent's federal estate tax return is filed.⁶⁶ Of course, a beneficiary cannot assign or "transfer" a retirement plan distribution. But if an alien spouse receives a single-sum distribution and pays the proceeds into a QDOT before the estate tax return is filed, it might qualify for the marital deduction.

The Treasury regulations also provide a special rule for annuity payments, but that rule is unlikely to be useful.⁶⁷

State Death Taxes

In addition to the federal estate tax, most states impose some form of death transfer tax. An estate tax is a tax on the privilege of transferring property from a decedent. An inheritance tax is a tax on the privilege of receiving property from a decedent, including even property that the decedent did not own at the time of his or her death. Unlike the marital deduction available under the federal estate tax, an inheritance tax or a state estate tax might apply even when the beneficiary is the decedent's spouse.

An explanation of particular states' inheritance or death transfer taxes is beyond the scope of this chapter. Some states tax retirement benefits for death transfer tax purposes according to rules similar to those for the federal estate tax. Other states have their own rules. In several states, the tax varies based on the relationship of the beneficiary to the participant-decedent. Some states do not tax life insurance proceeds in some circumstances.

Giving Advice About a Beneficiary Designation

A CPA might affirmatively present suggestions about beneficiary designations, especially in the course of an estate planning or other financial planning engagement. Or, a CPA might respond to a client's questions about a beneficiary designation.

⁶⁵ See, e.g., Let. Rul. 9713018 (Dec. 27, 1996).

⁶⁶ IRC Section 2056(d)(2)(B)(i).

⁶⁷ Treas. Reg. Section 20.2056A-4.

Financial Planning

Depending on the scope of a financial planning engagement, a CPA might ask a client about beneficiary designations. A person's right to name a beneficiary is a valuable right, and it is part of his or her financial planning. A professional would not want a client to lose a valuable opportunity just because the client was neglectful.

Further, asking someone who he or she named as his or her beneficiary often leads to a conversation about why the client wants to provide for the particular beneficiary. It often leads to a conversation about a family's life and financial needs. And it can help a CPA open a conversation about how he or she might offer accounting, tax advice, and consulting services to meet some of those needs.

Reading a Beneficiary Designation Form

Plan administrators design beneficiary designation forms anticipating the possibility that a participant might give incomplete or ambiguous instructions. For example, many forms provide that—if a participant has not specified the shares—an account will be divided among all beneficiaries in equal shares.

A beneficiary designation form might include other “gap-fillers” or “default” provisions, some of which might be surprising to a participant. For example, a beneficiary designation form might provide that a beneficiary change for an account will change the beneficiary for *every* account with the provider that is classified under the same IRC subsection. Some defined contribution retirement plans provide as a “default” beneficiary the person or persons designated under a pension plan or even a life insurance plan. Because provisions of this kind might frustrate one's intent, a careful participant should read the beneficiary designation form.

Answering a Client's Questions

A CPA may give practical advice about how to fill-in the beneficiary information requested by a retirement plan's forms. However, he or she must not give advice about the legal effect of a beneficiary designation, unless that advice is incidental to tax advice that the CPA properly renders.

As mentioned earlier, except when done by a lawyer, giving legal advice, even for free, is a crime in almost every state. Even if a nonlawyer clearly warns that he or she is not a lawyer, it is still a crime to give legal advice. That a nonlawyer furnished information to a person who could not afford the services of a lawyer is not a defense to the nonlawyer's unauthorized practice of law.

Note. The author asks readers to understand that this chapter's description of the law does not reflect his view about what the law ought to be. Rather, he believes that any person should be free to give legal advice (and to bear responsibility for his, her, or its advice).

Even if he or she is not worried about criminal prosecution or losing his or her accounting or other licenses, a CPA might be more concerned about liability to his or her client. A person's warning that he or she has not given legal advice does not protect him or her from responsibility if in fact he or she gave legal advice. Even a client's signature on a written confirmation that a person had not given legal advice does not protect the person if in fact he or she gave legal advice. Courts have not hesitated to impose liability on a nonlawyer for giving incorrect or even incomplete advice. It is not a defense that a reasonable person should know that he or she cannot expect legal advice from a nonlawyer; instead, courts have found that circumstances sometimes make it reasonable to believe a nonlawyer would give legal advice. A nonlawyer will be held to the same standard of care and expertise as a lawyer. This duty, even for a nonlawyer, includes a duty to have and use specialist expertise, or to refer one's client to an appropriate specialist.

Practice Pointer: A CPA's malpractice insurance contract cannot cover the practice of law. Also, notwithstanding exceptions for professionals, a CPA who renders advice or makes statements beyond his or her licensed profession remains vulnerable to claims and remedies under a state's consumer-fraud statute.

Many people believe that they cannot afford legal advice. Although a CPA should urge a client to seek a lawyer's advice, often it is impractical to avoid a client's questions. Try to answer questions by referring to widely known general information that does not involve applying the law to a specific factual situation.

Practice Pointer: If someone wants to make a beneficiary designation that would provide anything less than 100 percent of his or her death benefit for his or her spouse, urge him or her to seek the advice of an expert lawyer.

Involving Other Professionals

Making a beneficiary designation under a retirement plan or an IRA is an important part of estate planning. Although a plan's benefit will not pass by a will (as explained earlier), a beneficiary designation affects a person's overall estate plan.

A participant should make sure that his or her lawyer knows what beneficiary designation he or she made under each plan, and should ask the lawyer for advice about whether to change any beneficiary designation. Likewise, if a client looks to a CPA for advice in planning concerning estate and inheritance taxes, such a participant should give the CPA copies of all beneficiary designations.⁶⁸

Experts on the law of wills, trusts, and estates have observed that many Americans die with several "wills"—maybe one that was written in a lawyer's office and a dozen others that were filled out on standard forms. For most people, those forms—that is, beneficiary designations—dispose of far more money and property than the will does.

Common Mistakes

Because people enroll in retirement plans quickly, they sometimes make beneficiary designations that are less than carefully considered. Consider the following explanation of some common mistakes:

1. *Failing to coordinate a beneficiary designation's provisions with those made in other nonprobate designations, trusts, and a will.* Although a beneficiary designation's provisions need not be the same as those of a participant's will or other dispositions, if they are different the maker should understand why he or she has made different provisions and whether they are likely to add up to a combined result that he or she wants.
2. *Failing to consider whether a beneficiary designation is consistent with tax-oriented planning.* A participant might have had a lawyer's or CPA's advice about how to leave his or her estate, including both probate and nonprobate property, to achieve a desired tax outcome. Making a beneficiary designation without counting its effect on the maker's tax-oriented plan could result in an unanticipated tax.
3. *Making a beneficiary designation that a plan administrator or payer will refuse to implement.* For example, a person might try to make a beneficiary designation that refers to terms that one may use

⁶⁸ See also *The Team Approach to Tax, Financial & Estate Planning* by Lance Wallach (AICPA, 2003).

in a will or trust but are precluded by his or her retirement plan. A plan administrator's or payer's interpretation of the beneficiary designation without the offending terms might result in a disposition quite different from what the participant would have wanted.

4. *Trying to name beneficiaries by writing "all my children, equally" or describing a class.* Whenever a beneficiary designation refers to information not in a retirement plan's records, a plan administrator or payer may decide that the participant did not make a beneficiary designation, or might allow a claimant an opportunity to name every person in the class and prove that there are no others. Since it is difficult to prove the nonexistence of an unidentified person, even the opportunity to correct such a beneficiary designation would result in significant frustration and delay.
5. *Neglecting to use a beneficiary's Social Security Number or Individual Taxpayer Identification Number, especially for a daughter.*

Example. Gary Smith named his three children—Reed Smith, Catherine Smith, and Alice Smith—as his beneficiaries, and used only their names. By the time of Gary's death many years later, Reid and Alice had married. Reed had no special difficulty claiming his benefit. But Alice Carpenter was required to submit proof that she is the same person as Alice Smith. Because an identifying number assigned by the Social Security Administration or IRS is unique, this burden could have been avoided had Gary put Alice's number on the beneficiary designation form.

Caution: *Some participants will want to balance this use of a clear identifier against concerns about a potential for identity theft.*

6. *Naming a minor as a beneficiary without considering who the minor's conservator would be.* For example, a divorced person might not want to name his or her young child as a beneficiary if doing so might have the effect of putting money in the hands of the child's other parent, namely, the participant's former spouse. Instead, a participant might name a suitable trustee or custodian.
7. *Naming a child as a beneficiary without considering his or her prudence.*

Example. Ralph names his daughter, Britney, as beneficiary of Ralph's custodial account. When Ralph dies, Britney is 19 years old, and no longer is a minor under applicable law. Although Britney should pay her sophomore year's \$25,000 tuition at the Newark College of Fashion Arts, Britney buys a new car, and then neglects to pay the second insurance premium. When the uninsured car is stolen, Britney has nothing left from her father's gift.

8. *A participant who wants to benefit his or her child might consider that person's maturity, and consider whether it could help to choose a suitable trustee to manage the child's benefit.*
9. *Forgetting to give a copy of the beneficiary designation to the beneficiary.* A plan administrator or payer has no duty or obligation to contact a participant's beneficiaries to invite them to submit a claim. Indeed, many financial services providers particularly avoid doing so because such a communication might invite fraudulent claims. A beneficiary might not claim a benefit if he or she is unaware that he or she is a beneficiary. Likewise, a beneficiary might face difficulty in claiming a benefit if he or she does not know the name of the plan administrator or payer.
10. *Naming one's estate as his or her beneficiary.* Some participants think that naming one's estate as beneficiary is a way to avoid inconsistency in his or her estate plan. Although such a beneficiary designation might fulfill a goal of avoiding inconsistency, it bears other consequences, which might be disadvantageous. Amounts paid or payable to an executor or personal representative for the estate

are available to a decedent's creditors. And a benefit's "run" through an estate might, because of accounting and timing differences, result in income taxes greater than the income tax that would result if the recipient received the benefit directly.⁶⁹

11. *Although this observation might seem somewhat inconsistent with some just described, another common mistake is failing to make a beneficiary designation.* A participant who has difficulty making up his or her mind about a beneficiary designation is unlikely to have read a plan's documents carefully enough to understand the effect of the plan's "default" provision. Although a young person might assume that death is far away, the point of a beneficiary designation is to provide for the possibility of death.

Practice Pointer: When a CPA senses "analysis paralysis," he or she might suggest that the risks of failing to make a beneficiary designation outweigh the risks of a less than perfectly considered beneficiary designation. Remind a client that a typical plan allows a participant to change his or her beneficiary designation at any time.

12. *Forgetting to review one's beneficiary designation.* A participant should review his or her beneficiary designations on a periodic basis, and whenever there is a significant change in his or her family or wealth.

Example. Nancy named her husband, Larry, as her beneficiary under an ERISA plan. Although Nancy wanted to make sure that her children would be provided for, she trusted her husband to take care of the whole family. Nancy and Larry divorced, and Nancy neglected to change her beneficiary designation. After Nancy's death, Larry submits his claim to the plan administrator. The plan administrator follows the plan's terms, which do not revoke a beneficiary designation because of a participant's divorce. The plan pays Larry, and he spends the money without considering any needs of Nancy's children.

The examples and common mistakes explained above are only a few of the many ways a participant might make an unwise beneficiary designation. Although a retirement benefit is meant to be consumed mostly during a participant's retirement years, death always is possible. So a participant should use his or her valuable right to name a beneficiary, and use that right with care.

Additional Resources

This list is arranged in alphabetical order of the publishers.

AICPA Resources on Professional Practices

The following resources focus on the professional practices and procedures a CPA should use in performing services mentioned in this chapter:

- American Institute of Certified Public Accountants (AICPA) www.AICPA.org.
- AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans* (2007).

⁶⁹ IRC Sections 1, 72, 641-691.

- Anthony E. Davis, Marcia Gordon, and Robert H. Spencer, *Risk Management: A CPA Toolkit for a Changing Environment* (2003).
- Lance Wallach, *A CPA's Guide: The Team Approach to Tax, Financial & Estate Planning*, AICPA (2004).
- These publications are available at *www.CPA2biz.com*.

Pension Answer Book Series (Aspen Publishers)

Primarily question and answer format of particular topics in the pension area, relevant titles include:

- SIMPLE, SEP, and SARSEP Answer Book
- Quick Reference to IRAs
- 403(b) Answer Book
- 457 Answer Book
- Roth IRA Answer Book

Resources on Laws That Relate to Beneficiary Designations

Although a CPA who is not also a lawyer is unlikely to render specific legal advice about the effect of a beneficiary designation, a general background in relevant law might improve a CPA's accounting, auditing, financial planning, and tax services. The following resources focus on broad patterns of laws in the United States.

American Law Institute

- Restatement of the Law Governing Lawyers (2001)
- Restatement of the Law of Conflict of Laws (1957)
- Restatement of the Law of Property—Wills and Other Donative Transfers (1999)
- Restatement of the Law of Trusts (1959)

National Conference of Commissioners on Uniform State Laws

- Determination of Death Act (1980)
- Disclaimer of Property Interests Act (1999)
- Disposition of Community Property Rights at Death Act (1971)
- Durable Power of Attorney Act (1987)
- Marital Property Act (1983)
- Marriage and Divorce Act (1973)
- Nonprobate Transfers on Death (1989)
- Notarial Acts (1982)
- Premarital Agreement Act (1983)
- Principal and Income Act (2001)
- Probate Code (1998)
- Simultaneous Death Act (1993)
- Transfers to Minors Act (1986)
- Transfers under Nontestamentary Instruments Act (1978)
- Trust Code (2000)
- Unclaimed Property Act (1995)

Chapter 22

Form 5500 Series Filing Requirements and Audit Waivers for Small Pension Plans

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This chapter discusses the general Form 5500 and Form 5500-EZ filing requirements, exceptions from filing Forms 5500 and 5500-EZ, and the conditions for small employee-benefit plans (generally those with fewer than 100 participants) to be exempt from the general requirement that plans be audited each year by an independent qualified public accountant (IQPA) as part of the plan's annual report on Form 5500, when applicable.

Form 5500 Series Filing Requirements

The Form 5500 Series, Annual Return/Report of Employee Benefit Plan, is used to report information concerning employee-benefit plans and direct filing entities (DFEs). The administrator or sponsor of an employee-benefit plan subject to ERISA must file information about each plan every year. Various schedules may have to be attached.

The Internal Revenue Service (IRS), Department of Labor (DOL), and Pension Benefit Guaranty Corporation (PBGC) have consolidated certain returns and report forms to reduce the filing burden for plan administrators and employers. Employers and administrators who comply with the instructions for the Form 5500 and schedules will generally satisfy the annual reporting requirements for the IRS and DOL¹ with that agency.

¹ PBGC covered plans have special additional requirements, including filing an Annual Premium Payment (PBGC Form 1 Packages) and reporting certain transactions directly.

Who Must File Form 5500, Annual Return/Reports

Unless otherwise exempt, a Form 5500, Annual Return/Report, must be filed every year for every pension-benefit plan, welfare-benefit plan, and for every entity that files as a direct filing entity (DFE).²

Pension-Benefit Plan

All *pension-benefit plans* covered by the Employee Retirement Income Security Act of 1974, as amended (ERISA) are generally required to file a Form 5500. The return/report is due whether or not the plan is qualified, and even if benefits no longer accrue, contributions were not made during the plan year, or contributions have been discontinued. Pension-benefit plans required to file include both defined benefit plans and defined contribution plans. The following are among the pension-benefit plans for which an annual return and report must be filed:

1. Profit-sharing, stock bonus, money-purchase, and 401(k) plans, including savings incentive match plans for employees (SIMPLE), SIMPLE 401(k) plans, and so on
2. Annuity arrangements under Internal Revenue Code (IRC or the Code) Section 403(b)(1)
3. Custodial accounts established under IRC Section 403(b)(7) for regulated investment company stock
4. IRA established by an employer under IRC Section 408(c)
5. Pension-benefit plans maintained outside the United States primarily for nonresident aliens, if the employer who maintains the plan is a domestic employer or a foreign employer with income derived from sources within the United States (including foreign subsidiaries of domestic employers) if contributions to the plan are deducted on its U.S. income tax return
6. Church pension plans electing coverage under IRC Section 410(d)
7. Pension-benefit plans that cover residents of Puerto Rico, the U.S. Virgin Islands, Guam, Wake Island, or American Samoa³

Form 5500 Schedules

The following schedules may be required to be attached to Form 5500:

- *Schedule A, Insurance Information.* This is required if any benefits under an employee-benefit plan are provided by an insurance company, insurance service, or other similar organization.⁴ This includes investment contracts with insurance companies, such as guaranteed investment contracts (GIC) and pooled separate accounts (PSA).

Note. Schedule A is not required for an administrative services only (ASO) contract or if a Schedule A is filed for the contract as part of the Form 5500 filed directly by a master trust investment account. In addition, Schedule A is not required if the plan covers only (1) an individual or an individual and his or her spouse who wholly own a trade or business, whether incorporated or unincorporated; or (2) partners or partners and one or more of the partners' spouses in a partnership.

² IRC Section 6058; ERISA Sections 104 and 4065.

³ This includes a plan covering residents of Puerto Rico that elects to have the provisions of ERISA Section 1022(i)(2) regarding exemption from tax apply.

⁴ Such as Blue Cross, Blue Shield, or a health maintenance organization.

- *Schedule B, Actuarial Information.* Actuarial information is required for most defined benefit pension plans and for defined contribution pension plans that currently amortize a waiver of the minimum funding.
- *Schedule C, Service Provider Information.* Service provider information is required for a large plan or group insurance arrangement (GIA) if:
 - Any service provider who rendered services to the plan or DFE during the plan or DFE year received \$5,000 or more in compensation, directly or indirectly from the plan or DFE, or
 - An accountant and/or enrolled actuary has been terminated.
- *Schedule D, DFE/Participating Plan Information.* This schedule captures DFE and participating plan information. Part I is required for a plan or DFE that invested or participated in any master trust investment account (MTIA), 103-13 investment entity (IE),⁵ common/collective trust (CCT), and/or in a group insurance arrangement (GIA). However, plans that participate in CCT, PSA, GIA, or 103-12 Investment Entities (IEs) that file as DFEs generally are eligible for certain annual reporting relief.

Caution: Different requirements apply to the Schedules D and H attached to the Form 5500 filed by plans and DFEs participating in CCTs and PSAs, depending upon whether a DFE Form 5500 has been filed for the CCT or PSA. See the instructions for these schedules.

- *Schedule E, ESOP Annual Information.* Employee stock ownership plan (ESOP) annual information is required for all pension benefit plans with ESOP benefits. For additional information, see the Schedule E instructions.
- *Schedule G, Financial Transaction Schedules.* Financial transaction information is required for a large plan, MTIA, IE, or GIA when Schedule H, Financial Information lines 4b, 4c, and/or 4d are checked *yes*. Part I of the Schedule G reports loans or fixed income obligations in default or classified as uncollectible. Part II of the Schedule G reports leases in default or classified as uncollectible. Part III of the Schedule G reports nonexempt transactions.

Note. An unfunded, fully insured, or combination unfunded/insured welfare plan with 100 or more participants exempt from completing Schedule H⁶ must still complete Schedule G, Part III, to report any nonexempt transactions.

- *Schedule H, Financial Information.* Financial information is required for pension-benefit plans filing as *large plans*, and for all DFE filings. Schedule H filers are generally required to engage an IQPA and attach a report.⁷ These plans and DFEs are also generally required to attach to the Form 5500 a Schedule of Assets (Held At End of Year), and, if applicable, a Schedule of Assets (Acquired and Disposed of Within Year), and a Schedule of Reportable Transactions. For additional information and exceptions, see the Schedule H instructions.

⁵ DOL Reg. Section 2520.103-12 provides an alternative method of reporting for plans that invest in an entity (other than a MTIA, CCT, or PSA), whose underlying assets include plan assets. See DOL Reg. Section 2510.3-101.

⁶ DOL Reg. Section 2520.104-44.

⁷ Pursuant to ERISA Section 103(a)(3)(A).

- *Schedule I, Financial Information.* Financial information is required for all pension-benefit plans filing as *small plans*, except for certain unfunded plans, certain insured plans and arrangements,⁸ and limited plan reporting situations.
- *Schedule R, Retirement Plan Information.* This is required for a pension-benefit plan that is a defined benefit plan or is otherwise subject to IRC Section 412 or ERISA Section 302 regarding minimum funding requirements. Schedule R may also be required for certain other pension benefit plans unless exempt.
- *Schedule SSA, Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits.* This may be needed to report separated participants.

Note. For plan years beginning in 2006, the Internal Revenue Service no longer requires Schedule P and it was eliminated. Schedule T was eliminated by the Internal Revenue Service for plan years beginning in 2005.

Limited Plan Reporting

Certain plans and arrangements are eligible for limited annual reporting. They are:

- *403(b) Arrangements.* A pension plan or arrangement using a tax deferred annuity arrangement under IRC Section 403(b)(1) and/or a custodial account for regulated investment company stock under IRC Section 403(b)(7) as the sole funding vehicle for providing pension benefits need complete only Form 5500, Part I and Part II, lines 1 through 5, and 8 (enter pension feature code 2L, 2M, or both).

Note. The administrator of an arrangement described above is not required to engage an IQPA, attach an accountant's opinion to the Form 5500, or attach any schedules to the Form 5500.

- *IRA Plans.* A pension plan utilizing individual retirement accounts or annuities⁹ as the sole funding vehicle for providing pension benefits need complete only Form 5500, Part I and Part II, lines 1 through 5, and 8 enter pension feature code 2N.
- *Fully Insured Pension Plan.* Special reporting requirements apply to a pension-benefit plan providing benefits exclusively through an insurance contract or contracts that are fully guaranteed and that meet special requirements during the entire plan year.¹⁰ Such a plan is exempt from attaching Schedule H, Schedule I, and an accountant's opinion, and from the requirement to engage an independent qualified public accountant.
- *Nonqualified Pension-Benefit Plans Maintained Outside the United States.* Nonqualified pension-benefit plans maintained outside the United States primarily for nonresident aliens required to file a return and report must complete the Form 5500 only enter 3A in Part II, line 8a.

Short Plan Year Rule

If the plan had a short plan year of seven months or less for either the prior plan year or the plan year being reported on the Form 5500, an election can be made to defer filing the accountant's report.¹¹ If such an election was made for the prior plan year, the Form 5500 must be completed following the requirements for a

⁸ DOL Reg. Section 2520.104-44(b)(2).

⁹ IRC Section 408.

¹⁰ DOL Reg. Section 2520.104-44(b)(2).

¹¹ DOL Reg. Section 2520.104-50.

large plan, including the attachment of the Schedule H and the accountant's reports, regardless of the number of participants entered in Part II, line 6.

Small Pension Plans

Generally, a return and report filed for a pension-benefit plan that covered fewer than 100 participants as of the beginning of the plan year should be completed following the requirements for a *small plan*. A return and report filed for a plan that covered 100 or more participants as of the beginning of the plan year should be completed following the requirements below for a *large plan*.

Practice Pointer: Use the number of participants required to be entered in line 6 of the Form 5500 to determine whether a plan is a small plan or large plan.

The 80-120 Participant Rule Exception

If the number of participants reported on line 6 is between 80 and 120, and a Form 5500 was filed for the prior plan year, the plan administrator or sponsor may elect to complete the return and report in the same category (large plan or small plan) as was filed for the prior return and report.

Example. A return and report was filed for the 2005 plan year as a small plan, including the Schedule I if applicable, and the number entered on line 6 of the 2006 Form 5500 is 100 to 120. The plan administrator or sponsor may elect to complete the 2006 Form 5500 and schedules in accordance with the instructions for a small plan.

Example. A return and report was filed for the 2005 plan year as a large plan, and the number entered on line 6 of the 2006 Form 5500 is 80 to 99. This plan is permitted to file the 2006 Form 5500 as a small plan, because the number of participants on line 6 of Form 5500 is 99 or less. However, under the 80-120 rule, the plan administrator or sponsor may elect to complete the 2006 Form 5500 and schedules in accordance with the instructions for a large plan.

Practice Pointer: The 80-120 rule permits a small plan to continue filing as a small plan and avoid the expense associated with obtaining an accountant's opinion as long as the participant count on line 6 of Form 5500 is 120 or less and the prior year Form 5500 was filed as a small plan. The 80-120 rule can be applied for more than one year. Thus, a small plan filer might have more than 100 (but never more than 120) participants reported on line 6 for several years. However, once the plan files Form 5500 as a large plan, it must continue to file as a large plan until the participant count on line 6 of Form 5500 is 99 or less.

The following schedules, including any additional information required by the instructions to the schedules, must be attached to a Form 5500 filed for a small pension plan:

1. Schedule A (as many as needed), to report insurance, annuity, and investment contracts held by the plan
2. Schedule B, to report actuarial information, if applicable
3. Schedule D, Part I, to list any CCT, PSA, MTIA, and IE in which the plan participated at any time during the plan year
4. Schedule E, to report ESOP annual information, if applicable

5. Schedule I, to report small plan financial information, unless exempt

Practice Pointer: If Schedule I, line 4k, is checked no, attach a report of the IQPA or a statement that the plan is eligible and elects to defer attaching the IQPA's opinion "pursuant 29 CFR 2520.104-50" in connection with a short plan year of seven months or less.

6. Schedule R, to report retirement plan information, if applicable
7. Schedule SSA (as many additional page 2s as needed), to report separated vested participant information, if applicable

Large Pension Plans

The following schedules, including any additional information required by the instructions to the schedules, must be attached to a Form 5500 filed for a large pension plan:

1. Schedule A (as many as needed), to report insurance, annuity, and investment contracts held by the plan
2. Schedule B, to report actuarial information, if applicable
3. Schedule C, to list the 40 most highly compensated service providers and, if applicable, any terminated accountants or enrolled actuaries
4. Schedule D, Part I, to list any CCTs, PSAs, MTIAs, and IEs in which the plan invested at any time during the plan year
5. Schedule E, to report ESOP annual information, if applicable
6. Schedule G, to report loans or fixed income obligations in default or determined to be uncollectible as of the end of the plan year, leases in default or classified as uncollectible and nonexempt transactions
7. Schedule H, to report financial information, unless exempt

Practice Pointer: Attach the report of the IQPA identified on Schedule H, line 3c, unless line 3d(2) is checked.

8. Schedule R, to report retirement plan information, if applicable
9. Schedule SSA (as many additional page 2s as needed), to report separated vested participant information, if applicable

Arrangements Not Required to File Form 5500

Form 5500 is not required for a plan if the plan is:

1. An unfunded excess-benefit plan¹²
2. An annuity or custodial account arrangement under IRC Section 403(b)(1) or (7) not established or maintained by an employer¹³
3. A SIMPLE utilizing SIMPLE IRAs¹⁴
4. A simplified employee pension (SEP) or a salary-reduction or elective SEP (SARSEP) that conforms to either of the alternative method of compliance¹⁵

¹² ERISA Section 4(b)(5).

¹³ DOL Reg. Section 2510.3-2(f). No contributions are made by the employer and the employer's involvement is limited.

¹⁴ IRC Section 408(p).

5. A church plan not electing coverage under IRC Section 410(d)
6. A pension plan that is a qualified foreign plan¹⁶
7. An unfunded pension plan for a select group of management or highly compensated employees (top-hat plan) that has timely filing of a registration statement with the DOL¹⁷
8. An unfunded dues financed pension-benefit plan that meets the alternative method of compliance¹⁸
9. An IRA not considered a pension plan under ERISA, meaning that no contributions are made by the employer and the employer's involvement is limited.¹⁹
10. A governmental plan²⁰

Form 5500-EZ

Form 5500-EZ may be filed instead of Form 5500 if all of the following conditions apply:

1. The plan is the one-participant plan of an incorporated or unincorporated business and the plan either covers only:
 - a. A sole-proprietor or a sole-proprietor and his or her spouse; or
 - b. One or more partners (or partner(s) and spouse(s)) in a business partnership.
2. The plan meets the minimum coverage requirements of IRC Section 410(b) without being combined with any other plan covering other employees of a business (see 2006 instructions for line 14c for more information).
3. The plan does not provide benefits for anyone except you, or you and your spouse, or one or more partners and their spouses.
4. The plan does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control.
5. The plan does not cover individuals of a business that uses leased employees.

Form 5500-EZ (or Form 5500) does not have to be filed if the preceding five conditions are satisfied, the plan does not have an accumulated funding deficiency²¹ for the plan year, and the plan:

- Is a one-participant plan that had total plan assets of \$100,000 or less at the end of every plan year beginning on or after January 1, 1994, or
- When combined with one or more one-participant plans, has total plan assets of \$100,000 or less at the end of every plan year beginning on or after January 1, 1994.

Note. Effective beginning with calendar plan year 2005, filers of Form 5500-EZ are no longer required to file any schedules or attachments with the Form 5500-EZ. However, filers must collect and retain completed and signed Schedule B (Actuarial Information), if applicable. This change does not eliminate the requirement to both perform an annual valuation and maintain the funding standard account for all plans subject to the minimum funding requirements of Internal Revenue Code Section 412.

¹⁵ IRC Section 408(k); DOL Reg. Section 2520.104-48 or 2520.104-49.

¹⁶ IRC Section 404A(e).

¹⁷ DOL Reg. Section 2520.104-23.

¹⁸ DOL Reg. Section 2520.104-27.

¹⁹ DOL Reg. Section 2510.3-2(f). See, too, DOL Reg. Section 2510.3-2(d).

²⁰ ERISA Sections 3(32), 4(b)(1).

²¹ As defined in IRC Section 412(a)(2).

Audit Waivers for Small Pension Plans

The DOL's regulation establishes conditions for small employee-benefit plans (generally those with fewer than 100 participants) to be exempt from the general requirement under Title I of ERISA that plans be audited each year by an IQPA as part of the plan's annual report, namely, Form 5500.²²

Plans Eligible for Waiver

Retirement plans with fewer than 100 participants at the beginning of the plan year are eligible for an audit waiver if they meet certain conditions. All Schedule I, Financial Information—Small Plan, filers that meet the conditions of the audit waiver are eligible. If the plan meets the conditions of the "80-120 Participant Rule Exception," it may file as a small plan and attach Schedule I instead of Schedule H to its Form 5500. Under the 80-120 rule, if the number of participants covered under the plan as of the beginning of the plan year is between 80 and 120, and a small plan annual report was filed for the prior year, the plan administrator may elect to continue to file as a small plan.²³ The plan administrator must disclose to participants, beneficiaries and the DOL that it is claiming the waiver.²⁴

Example. Schedule I was filed for the plan for the 2005 plan year and the plan covered fewer than 121 participants as of the beginning of the 2006 plan year. Schedule I may be completed instead of Schedule H.

If a plan meets another exception to the IQPA audit requirement, for example, if it is a small plan that is not required to complete Schedule I (such as a SEP that is exempt from the audit requirement), it does not have to meet the conditions for an audit waiver.

Caution: *A small plan electing to file as a large plan pursuant to the 80-120-Participant Rule can not claim the small plan audit waiver.*²⁵

Note. Small plans that do not meet the audit waiver conditions still file Schedule I, but must attach the report of an IQPA to their Form 5500.²⁶ Such filers also do not need to include a schedule of assets held for investment or a schedule of reportable transactions, Schedule C, or Schedule G.

General Conditions for Audit Waiver

In addition to being a small pension plan filing the Schedule I, there are three basic requirements for a small pension plan to be eligible for the audit waiver, as follows:

1. As of the last day of the preceding plan year, at least 95 percent of a small pension plan's assets must be qualifying plan assets. Alternatively, if less than 95 percent are qualifying plan assets, then any person who handles assets of a plan that do not constitute qualifying plan assets must be bonded in an amount that is at least equal to the value of the nonqualifying plan assets he or she handles.²⁷

²² DOL Reg. Section 2520.104-46 (43 FR 10151, Mar. 10, 1978, as amended at 43 FR 14010, Apr. 4, 1978; 45 FR 51447, Aug. 1, 1980; 54 FR 8629, Mar. 1, 1989; 65 FR 21067, Apr. 19, 2000; 65 FR 62957, Oct. 19, 2000).

²³ DOL Reg. Section 2520.104.46(d)(3).

²⁴ By checking *yes* on Line 4k of Schedule I of the Form 5500 filed for the plan.

²⁵ DOL Reg. Section 2520.104.46(d)(4).

²⁶ DOL Reg. Section 2520.104.46(d)(1).

²⁷ DOL Reg. Section 2520.104.46(b)(1)(i)(A).

2. The plan must include certain information in the Summary Annual Report (SAR) furnished to participants and beneficiaries in addition to the information ordinarily required.²⁸
3. In response to a request from any participant or beneficiary, the plan administrator must furnish without charge copies of statements the plan receives from the regulated financial institutions holding or issuing the plan's qualifying plan assets and evidence of any required fidelity bond.²⁹

Administrators can use Exhibit 22-1 to determine whether their plan meets the requirements for the audit waiver.

Qualifying Plan Assets

For the purposes of the audit waiver rules, *qualifying plan assets* are any of the following:³⁰

1. Any asset held by regulated financial institutions that is one of the following:
 - a. Banks or similar financial institutions, including trust companies, savings and loan associations, domestic building and loan associations, and credit unions
 - b. Insurance companies qualified to do business under the laws of a state
 - c. Organizations registered as broker-dealers under the Securities Exchange Act of 1934
 - d. Investment companies registered under the Investment Company Act of 1940
 - e. Any other organization authorized to act as a trustee for IRAs under IRC Section 408(n)
2. Shares issued by an investment company registered under the Investment Company Act of 1940 (e.g. mutual fund shares)
3. Investment and annuity contracts issued by any insurance company qualified to do business under the laws of a state
4. In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished, at least annually, a statement from a regulated financial institution describing the plan assets held or issued by the institution and the amount of such assets
5. Qualifying employer securities, as defined in ERISA Section 407(d)(5)
6. Participant loans meeting the requirements of ERISA Section 408(b)(1), whether or not they have been deemed distributed

If more than five percent of the plan's assets are nonqualifying and the plan obtains bonding and otherwise meets the waiver requirements, it can still claim the audit waiver.

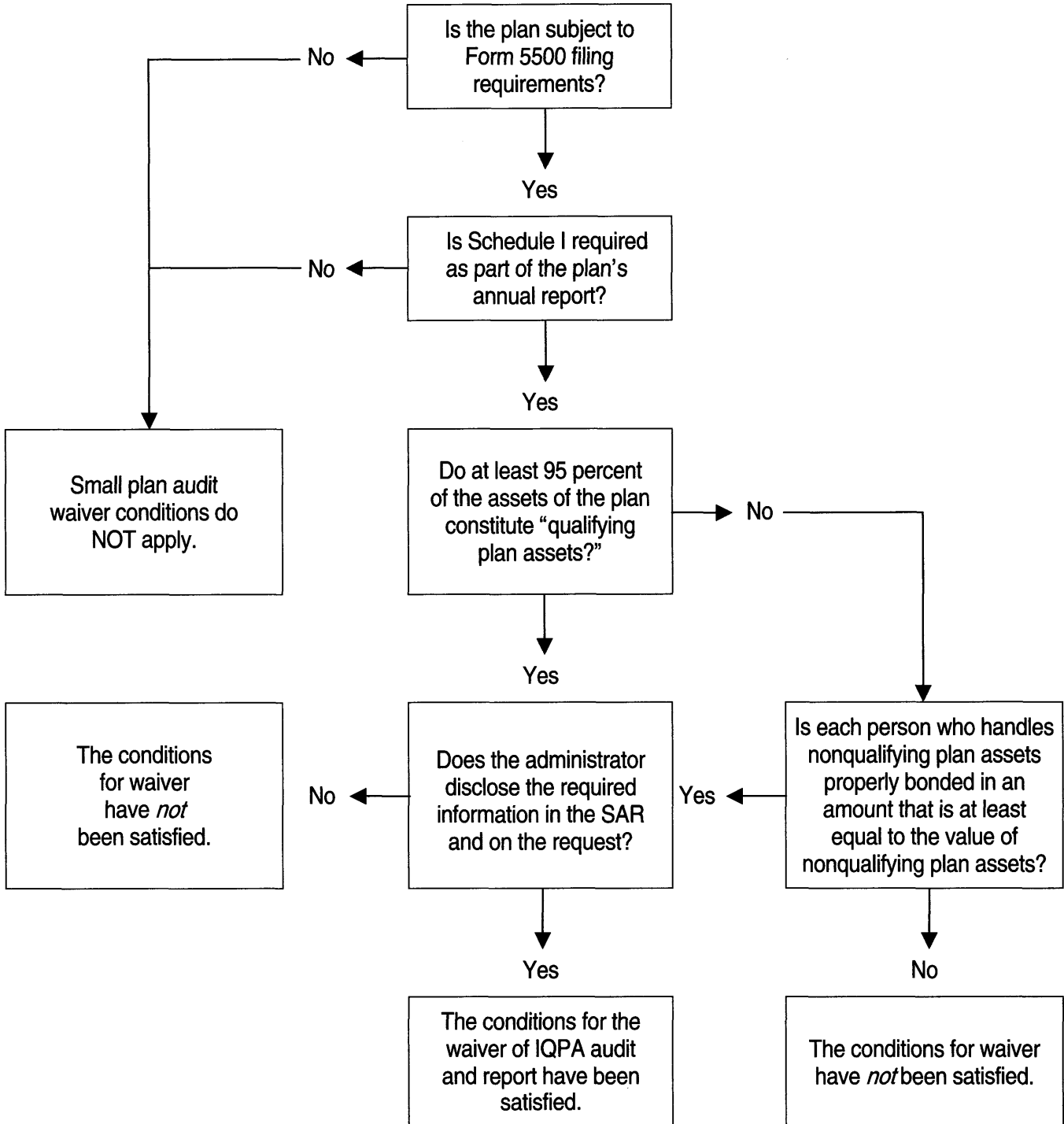
All plan assets that must be reported on the Form 5500, Schedule I line 1a, column (b) for the end of the prior plan year must be included in the calculation of qualifying and nonqualifying plan assets. The calculation must be made as soon as the information regarding the plan's assets at the close of the preceding plan year *practically* can be ascertained. This generally will be much sooner than the due date for filing the Form 5500 for that preceding plan year.

²⁸ DOL Reg. Section 2520.104.46(b)(1)(i)(B).

²⁹ DOL Reg. Section 2520.104.46(b)(1)(i)(C).

³⁰ DOL Reg. Section 2520.104.46(b)(1)(ii).

Exhibit 22-1. Small Plan Audit Waiver Summary



Adapted from DOL Reg. §2520.104-41(c) and §2520.104-46(b)(1) and (d).

In the initial plan year, the plan administrator may rely on estimates. The administrator should follow a similar method to the one described in 29 CFR 2580.412-15 for estimating the amount required for the ERISA Section 412 fidelity bond for an initial plan year.

Example. If a plan will be investing exclusively in assets that meet the definition of qualifying plan assets, for example, insurance contracts and mutual fund shares, bonding in addition to that required under ERISA Section 412 would not be necessary to meet the first condition for claiming the audit waiver.

If a new plan is initially funded through the transfer of assets from a predecessor plan, the percentage of qualifying plan assets is determined by treating the new plan as not having a preceding reporting year. The assets actually transferred from the predecessor plan are used to determine whether the new plan meets the 95-percent percentage condition for qualifying plan assets.

Account Type Requirements

The type of account the plan has with a regulated financial institution must generally be a trust or custodial account.³¹

Plan assets held in bank custodial, common or collective trust, or separate trust accounts, for example, are qualifying plan assets. In addition, securities held by a broker-dealer for the plan in an omnibus account are qualifying plan assets. Checking and savings accounts that create a debtor-creditor relationship between the plan and the bank are also qualifying plan assets for purposes of the audit waiver conditions.

Example. The Thrifty Plan stores plan assets in a safe deposit box with a bank with three gold keys. Plan assets stored in a safe deposit box would not be treated as qualifying plan assets.

Assets in Individual Participant Accounts

Assets in individual participant accounts can be treated as qualifying plan assets if the individual account statements from the regulated financial institutions are mailed by affiliates of the regulated financial institutions, other unaffiliated service providers, or the plan administrator. However, the account statements must be statements of the regulated financial institution, but the institution's regular distribution systems may be used to transmit the statements to participants and beneficiaries.³²

Example. A statement prepared by the XYZ regulated financial institution, on the XYZ's letterhead, including contact information that a participant could use to confirm the accuracy of the information in the statement with XYZ, could be given to the plan administrator for distribution to the plan participants and beneficiaries. However, a statement prepared by the plan administrator, even if based on data from the regulated financial institution, would not meet the audit waiver condition.

Fidelity Bond for Nonqualifying Assets

Persons that handle nonqualifying assets must be covered by a fidelity bond or bonds that meet the requirements of ERISA Section 412, except that the bond amount must be at least equal to 100 percent of the value the nonqualifying plan assets the person handles. Persons handling nonqualifying plan assets can rely on

³¹ DOL Reg. Section 2520.104.46(b)(1)(ii)(C).

³² DOL Reg. Section 2520.104.46(b)(1)(ii)(F).

normal rules and exemptions under ERISA Section 412 in complying with the audit waiver's enhanced bonding requirement.³³

Example. If the only nonqualifying assets that a person handles are not required to be covered under a standard ERISA Section 412 bond,³⁴ that person would not need to be covered under an enhanced bond for a plan to be eligible for the audit waiver.

If the plan has more than 5 percent of its assets in nonqualifying plan assets, the enhanced bond must cover all the nonqualifying assets not only those in excess of the 5-percent threshold. The person handling the nonqualifying plan assets can obtain his or her own bond. Also, a company providing services to the plan can obtain a bond covering itself and its employees that handle nonqualifying plan assets. The bond has to meet the requirements under ERISA Section 412, such as the requirements that the plan be named as an insured, that the bond not include a deductible or similar feature, and that the bonding company be on the Treasury Circular 570 list of approved surety companies (see the 2006 instructions for Schedule I, line 4e).³⁵

ERISA provides that persons that handle plan funds or other property generally must be covered by a fidelity bond in an amount no less than 10 percent of the amount of funds the person handles, and that, in no case, shall such bond be less than \$1,000 nor is it required to be more than \$500,000.³⁶ Effective for plan years beginning after December 31, 2007, the Pension Protection Act of 2006 increases the maximum bond amount to \$1 million in the case of a plan that holds employer securities.³⁷

If the enhanced fidelity bond alternative is being used and the nonqualifying plan assets exceed \$500,000, then the employer must purchase a bond covering all of the nonqualifying plan assets. In other words, there is no maximum bond amount under audit waiver conditions.

In some cases, 100 percent of the value of nonqualifying plan assets may be less than 10 percent of the value of all of the plan funds a person handles. Under those circumstances, the ERISA Section 412 bond covering the person will satisfy the audit waiver condition because the amount of the bond will be at least equal to 100 percent of the nonqualifying plan assets handled by that individual.

Example. Candace handles a total of \$1 million in plan funds, but only \$50,000 are nonqualifying plan assets. In that case, the ERISA Section 412 bond covering Candace should be equal to or greater than \$100,000, which would be more than the value of the nonqualifying assets Candace personally handles. For that person, the ERISA Section 412 bond would also satisfy the audit waiver enhanced bonding requirement. Even if the amount of an existing ERISA Section 412 bond is insufficient to meet the audit waiver requirement, plan administrators may want to consider increasing the coverage under the ERISA Section 412 bond rather than getting a new fidelity bond.

Summary Annual Report Disclosures

A plan administrator must include the following additional information in the SAR furnished to participants and beneficiaries to be eligible for the small pension plan audit waiver:³⁸

³³ DOL Reg. Section 2520.104.46(b)(1)(i)(A)(2).

³⁴ For example, employer and employee contribution receivables described in DOL Reg. Section 2580.412-5.

³⁵ See <http://www.fms.treas.gov/c570/c570.html>.

³⁶ ERISA Section 412.

³⁷ ERISA section 412(a) amended by PPA section 622.

³⁸ DOL Reg. Section 2520.104.46(c)(2)-(3).

1. Except as noted below, the name of each regulated financial institution holding or issuing qualifying plan assets and the amount of such assets reported by the institution as of the end of the plan year
2. The name(s) of the surety company issuing enhanced fidelity bonding, if the plan has more than five percent of its assets in nonqualifying plan assets
3. A notice indicating that participants and beneficiaries may, upon request and without charge, examine or receive from the plan copies of evidence of the required bond and copies of statements from the regulated financial institutions describing the qualifying plan assets

Practice Pointer: The normal ERISA bond is not required to be disclosed on the SAR. If an enhanced fidelity bond is not being used to meet the audit waiver conditions, then the name of the surety company that issues the normal ERISA bond need not be disclosed in the SAR and copies of same need not be offered.

4. A disclosure stating that participants and beneficiaries should contact the DOL's Employee Benefits Security Administration (EBSA) Regional Office if they are unable to examine or obtain copies of the regulated financial institution statements or, in the case of a plan relying on the enhanced fidelity bond, evidence of the required bond.

The enhanced SAR disclosure is not required for the following qualifying plan assets:

1. Qualifying employer securities as defined in Section 407(d)(5) of ERISA and the regulations issued thereunder
2. Participant loans meeting ERISA Section 408(b)(1) and the regulations issued thereunder
3. In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control provided the participant or beneficiary is furnished, at least annually, a statement from an eligible regulated financial institution describing the assets held or issued by the institution and the amount of such assets.

Even if 95 percent of the plan's assets are qualifying plan assets, to be eligible for the audit waiver, the SAR must include the required information on the regulated financial institutions holding or issuing the plan's qualifying plan assets.

Model Language

The regulations do not require that model language be used for the required enhanced SAR disclosures. As long as the SAR includes the required information, it will satisfy the audit waiver condition. The following language may assist administrators in composing SAR disclosures for their plans that would satisfy the regulation. Plan administrators will need to modify the notice to omit bonding or other information that is not applicable to their plan:

The U.S. Department of Labor's regulations require that an independent qualified public accountant audit the plan's financial statements unless certain conditions are met for the audit requirement to be waived. This plan met the audit waiver conditions for [insert year] and therefore has not had an audit performed.

Instead, the following information is provided to assist you in verifying that the assets reported in the Form 5500 were actually held by the plan.

At the end of the *[insert year]* plan year, the plan had (include separate entries for each regulated financial institution holding or issuing qualifying plan assets):

[Set forth amounts and names of institutions as applicable]

[Insert dollar amount] in assets held by *[Insert name of bank]*,

[Insert dollar amount] in securities held by *[Insert name of registered broker-dealer]*,

[Insert dollar amount] in shares issued by *[Insert name of registered investment company]*,

[Insert dollar amount] in investment or annuity contract issued by *[Insert name of insurance company]*

The plan receives year-end statements from these regulated financial institutions that confirm the above information. *[Insert as applicable: The remainder of the plan's assets were (1) qualifying employer securities, (2) loans to participants, (3) held in individual participant accounts with investments directed by participants and beneficiaries and with account statements from regulated financial institutions furnished to the participant or beneficiary at least annually, or (4) other assets covered by a fidelity bond at least equal to the value of the assets and issued by an approved surety company.]*

Plan participants and beneficiaries have a right, on request and free of charge, to get copies of the financial institution year-end statements and evidence of the fidelity bond. If you want to examine or get copies of the financial institution year-end statements or evidence of the fidelity bond, please contact *[insert mailing address and any other available way to request copies such as e-mail and phone number]*.

If you are unable to obtain or examine copies of the regulated financial institution statements or evidence of the fidelity bond, you may contact the regional office of the U.S. Department of Labor's Employee Benefits Security Administration for assistance by calling toll-free (866) 444-3272. A listing of EBSA regional offices can be found at www.dol.gov/ebsa. General information regarding the audit waiver conditions applicable to the plan can be found on the U.S. Department of Labor Website at www.dol.gov/ebsa under the heading, "Frequently Asked Questions."

Form 5500 Reporting Requirements

Certain employee benefit plans are exempt from the annual reporting requirements or are eligible for limited reporting options. The major classes of plans exempt from filing an annual report or eligible for limited reporting are described in the Form 5500 instructions.

The Form 5500 filed by plan administrators and GIAs is due by the last day of the 7th calendar month after the end of the plan or GIA year (not to exceed 12 months in length). See the Form 5500 instructions for information on extensions. The Form 5500 filed by DFEs other than GIAs are due no later than 9½ months after the end of the DFE year.

Plans and GIAs file the 2006 Form 5500 for the plan and GIA years that begin in 2006. In contrast, DFEs other than GIAs file the 2006 Form 5500 for DFE years that end in 2006.

The Quick Reference Chart that follows describes the basic filing requirements for small plans, large plans, and DFEs. Check the EFAST Internet site at www.efast.dol.gov and the latest Form 5500 instructions for information on who is required to file, how to complete the forms, when to file, EFAST approved software, and electronic filing options.

EBSA, in conjunction with the Internal Revenue Service (IRS) and the PBGC, publishes the Form 5500 Annual Return/Report forms used by plan administrators to satisfy various annual reporting obligations under ERISA and the Internal Revenue Code (Code). The Form 5500 is filed and processed under the ERISA Filing Acceptance System (EFAST). There are two formats for filing the Form 5500.

The first format, “machine print,” is completed using computer software from EFAST-approved vendors and can be filed electronically or by mail, including certain private delivery services. The other format, “hand print,” may be completed by typewriter, by hand, or by using computer software from EFAST-approved vendors, and may be filed only by mail, including certain private delivery services.

The Form 5500 filing requirements vary according to the type of filer. There are three general types of filers: small plans (generally plans with fewer than 100 participants as of the beginning of the plan year); large plans (generally plans with 100 or more participants as of the beginning of the plan year); and direct filing entities (DFEs). DFEs are trusts, accounts, and other investment or insurance arrangements that plans participate in and that are required to or allowed to file the Form 5500 directly with EBSA. These investment and insurance arrangements include master trust investment accounts (MTIAs), common/collective trusts (CCTs), pooled separate accounts (PSAs), 103-12 investment entities (103-12 IEs), and group insurance arrangements (GIAs). MTIAs are the only DFE for which the filing of the Form 5500 is mandatory. Employee benefit plans that participate in CCTs, PSAs, 103-12 IEs, and GIAs that file as DFEs are eligible for certain annual reporting relief.

Exhibit 22-2 shows a Quick Reference Chart adapted from Reporting and Disclosure Guide for Employee Benefit Plans (as reprinted August, 2006), published by the Department of Labor Employee Benefits Security Administration (EBSA) and is available at <http://www.dol.gov>

Exhibit 22-2. Quick Reference Chart: Form 5500, Schedules and Attachments

Section 1: Pension and Welfare Benefit Plan Quick Reference Chart: Form 5500, Schedules and Attachments¹								
	Large Pension Plan		Small Pension Plan		Large Welfare Plan		Small Welfare Plan	
Form 5500	Must complete. ²	Must complete. ²	Must complete. ²	Must complete. ²	Must complete.	Must complete. ³	Must complete. ³	Must complete. ³
Schedule A - Insurance Information	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits or investments.	Must complete if defined benefit plan and subject to minimum funding standards. ⁴	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits or investments.	Must complete if plan has insurance contracts for benefits ³ or investments.	Must complete if plan has insurance contracts for benefits ³ or investments.	Must complete if plan has insurance contracts for benefits ³ or investments.
Schedule B - Actuarial Information	Must complete if defined benefit plan and subject to minimum funding standards. ⁴	Must complete if defined benefit plan and subject to minimum funding standards. ⁴	Must complete if defined benefit plan and subject to minimum funding standards. ⁴	Must complete if defined benefit plan and subject to minimum funding standards. ⁴	Not required.	Not required.	Not required.	Not required.
Schedule C - Service Provider Information	Must complete if service provider was paid \$5,000 or more or an accountant or enrolled actuary was terminated.	Must complete if service provider was paid \$5,000 or more or an accountant or enrolled actuary was terminated.	Must complete if service provider was paid \$5,000 or more or an accountant or enrolled actuary was terminated.	Must complete if service provider was paid \$5,000 or more or an accountant or enrolled actuary was terminated.	Must complete if service provider was paid \$5,000 or more or an accountant or enrolled actuary was terminated.	Not required.	Not required.	Not required.
Schedule D - DFE/Participating Plan Information	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if a plan participates in a CCT, PSA, MTIA, or 103-12 IE.
Schedule E - ESOP Annual Information	Must complete if ESOP.	Must complete if ESOP.	Must complete if ESOP.	Must complete if ESOP.	Must complete if ESOP.	Not required.	Not required.	Not required.
Schedule G - Financial Transaction Schedules	Must complete if Schedule H, lines 4b, 4c, or 4d are required to be marked "Yes." ⁵	Must complete if Schedule H, lines 4b, 4c, or 4d are required to be marked "Yes." ⁵	Must complete if Schedule H, lines 4b, 4c, or 4d are required to be marked "Yes." ⁵	Must complete if Schedule H, lines 4b, 4c, or 4d are required to be marked "Yes." ⁵	Not required.	Must complete if Schedule H, lines 4b, 4c, or 4d are required to be marked "Yes." ^{5, 6}	Not required.	Not required.
Schedule H - Large Plan and DFE Financial Information	Must complete. ^{2, 5}	Must complete. ^{2, 5}	Must complete. ^{2, 5}	Must complete. ^{2, 5}	Must complete. ^{5, 7}	Must complete. ^{5, 7}	Not required.	Not required.
Schedule I - Small Plan Financial Information	Not required.	Not required.	Must complete. ²	Must complete. ²	Not required.	Not required.	Must complete. ³	Must complete. ³
Schedule R - Retirement Plan Information	Must complete, unless exempt. ⁸	Must complete, unless exempt. ⁸	Must complete, unless exempt. ⁸	Must complete, unless exempt. ⁸	Not required.	Not required.	Not required.	Not required.

¹See footnotes for certain exemptions and other technical requirements. All footnotes for this section are on page 423.

	Large Pension Plan	Small Pension Plan	Large Welfare Plan	Small Welfare Plan
Schedule SSA - Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits	Must complete if plan had separated participants with deferred vested benefits to report.	Must complete if plan had separated participants with deferred vested benefits to report.	Not required.	Not required.
Independent Qualified Public Accountant's Report	Must attach. ^{2,9}	Not required unless Schedule I, line 4k, is checked "No." ⁹	Must attach. ^{7,9}	Not required.

¹This chart provides only general guidance and not all rules and requirements are reflected. Refer to specific Form 5500 instructions for complete information on filing requirements.

²Pension plans are exempt from filing any schedules and the independent qualified public accountant's report if the plan uses a Code section 403(b)1 annuity and/or 403(b)7 custodial account, or 408 individual retirement account or annuity as the sole funding vehicle for providing benefits. Pension benefit plans providing benefits exclusively through an insurance contract or contracts that are fully guaranteed and that meet all of the conditions of 29 § CFR 2520.104-44(b)(2) during the entire plan year are exempt from filing Schedule H, Schedule I, and the independent qualified public accountant's report.

³Unfunded, fully insured and combination unfunded/insured welfare plans covering fewer than 100 participants at the beginning of the plan year that meet the requirements of 29 CFR § 2520.104-20 are exempt from filing an annual report.

⁴Must also complete if filed for a money purchase defined contribution plan required to amortize a waiver of the minimum funding requirements.

⁵Must also complete schedules of assets and reportable (5 percent) transactions if Schedule H, lines 4i or 4j, are marked "yes," but use of computer scannable form is not required.

⁶Must also complete to report any nonexempt transactions even if Schedule H is not required.

⁷Unfunded, fully insured and combination unfunded/insured welfare plans covering 100 or more participants at the beginning of the plan year that meet the requirements of 29 CFR § 2520.104-44 are exempt from the accountant's report requirement and completing Schedule H.

⁸Must complete if defined benefit plan or plan is otherwise subject to minimum funding requirements. Certain other pension plans also may be required to complete this schedule. See Schedule R instructions for further explanation.

⁹For information on the requirements for deferring an accountant's report pursuant to 29 CFR § 2520.104-50 in connection with a short plan year of 7 months or less and the contents of the required explanatory statement, see the Form 5500 instructions.

Key:
 DFE—Direct filing entities
 MTTA—Master trust investment accounts
 CCT—Common/collective trusts
 PSA—Pooled separate accounts
 IE—Investment entities
 GIA—Group insurance arrangements

Chapter 23

Fiduciary Duties to a Retirement Plan

BY PETER GULIA
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The basic theme of many retirement plans, especially the kinds most often used by small-business employers, seems simple enough. But a retirement plan—even a plan for very few people—is a complex entity with specialized requirements and many opportunities for conflicting interests. Almost always, an employer that maintains a retirement plan for its employees cannot avoid legal responsibility for managing those requirements and interests. Applicable law imposes a heightened duty of care, and in practical effect requires an employer to be or become an expert in retirement plan investments and administration.

To make this chapter manageable in size and format, the editor and author made some assumptions about the kinds of plans and situations that a reader would be likely to encounter. These assumptions are as follows:

- *Based on the book's title, a reader works with small businesses.*
- *Most small businesses have only a few owners.*
- *Most small businesses have few executives.*
- *Of those small businesses that have a retirement plan at all, most have an individual account or defined contribution plan, not a defined benefit plan.¹*
- *“Business” suggests seeking a profit, rather than a charitable or other tax-exempt organization.*
- *The business usually is not required to have audited financial statements.*
- *A retirement plan sponsored by a small business typically has fewer than 121 employees.*
- *A retirement plan sponsored by a small business typically does not have audited financial statements (see Chapter 22, Form 5500 Series Filing Requirements and Audit Waivers for Small Pension Plans).*

¹ If a business' owner is 40 or older and the business has no or few employees beyond owners and their spouses, a defined benefit plan might present attractive opportunities for large tax deductible contributions. For information about designing and funding a defined benefit plan, see Chapter 10.

- *A small business is most likely to maintain a single-employer plan, rather than participate in a multiple-employer or multiemployer plan.²*
- *A CPA is more likely to advise the business or an owner, and less likely to advise an employee.*

We used these assumptions to shorten this chapter's explanations, and to choose points that the book does not discuss at all.

Aware of the possibility that he might have guessed unwisely about which topics would be of interest to readers, the author invites readers to submit suggestions for new topics or questions that are about fiduciary duties to a retirement plan; the e-mail address is Peter@FiduciaryGuidanceCounsel.com.

The chapter ends with a classified list of resources about the law described in this chapter.³ To avoid a "legal tome" that would not serve this chapter's purpose as an overview of some of the most important fiduciary duties to retirement plan, the chapter does not include citations to support each statement about the law because many of these citations would not have been simple references to a statute or regulation, but rather layered citations involving the many⁴ court decisions (often conflicting) and U.S. Department of Labor documents that interpret the Employee Retirement Income Security Act of 1974 (ERISA) and trust law's general principles.

What is ERISA?

The *Employee Retirement Income Security Act of 1974* (ERISA) is an Act of Congress. Although that Act and later amendments to it have been codified in the United States Code (USC), practitioners and even generalist speakers and writers refer to the statute by the popular abbreviation, ERISA. Because changes to the Federal tax law are classified in the Internal Revenue Code, referring to ERISA usually means a discussion of the nontax laws that govern employee-benefit plans.

When it applies, ERISA governs the establishment, administration, and enforcement of an employee benefit plan, and preempts (with a few exceptions) State laws that would relate to a plan.

Which Plans are ERISA-Governed?

A "pension" or retirement plan is governed by ERISA if the plan's participants include at least one employee—not counting a self-employed business owner or an owner's spouse.⁵

² While an explanation of ERISA's and the Internal Revenue Code's definitions is beyond the scope of this chapter, a multiple-employer plan is a plan in which at least two employers participate and at least one participating employer is not controlled by, commonly controlled with, or affiliated with the other participating employers. A multiemployer plan similarly involves unrelated employers, but further is related to an employer's collective bargaining with a labor union.

³ The problems and issues that a professional would encounter concerning fiduciary duties to a retirement plan involve nontax law. Although many CPAs render tax advice, it is at least unwise, and might be unlawful, for a nonlawyer CPA to give advice about law other than tax law. While the author believes that any person should be free to give legal advice, America's legislatures have chosen otherwise. Therefore, this chapter's descriptions of situations that call for advice presume that a fiduciary would seek a lawyer's advice.

⁴ In 2006, about 10,000 new ERISA-breach lawsuits were filed in Federal courts. According to the U.S. Courts' Public Access to Court Electronic Records system, in 2006, 9,528 new civil cases were filed under code 791 (ERISA). PACER Civil NOS Search Result, <https://pacer.uspci.uscourts.gov/cgi-bin/dquery.pl> (9528 Total Case matches for selection NOS 791 01/01/2006 to 12/31/2006) [Thu Jan 25 10:31:39 2007]. This is less than the total because not all Federal courts report into the PACER system.

⁵ *Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon*, 541 U.S. 1 (2004). See also 29 C.F.R. § 2510.3-3.

Caution: *That a plan is not governed by ERISA does not mean that there are no fiduciary duties. Rather, fiduciary duties will be provided by State laws. Further, fiduciary duties and liabilities under State laws are often more demanding than those provided by ERISA.*

Some plans governed by ERISA generally might be exempt from some parts of ERISA. For example:

- An unfunded deferred compensation plan for a select group of management employees, or
- An agreement described in Internal Revenue Code Section 736 to provide pay to a retired or deceased partner (or his, her, or its successor), is exempt from ERISA's fiduciary responsibility provisions.⁶

Which Plans are Not ERISA-Governed?

A retirement plan is not governed by ERISA if it is a governmental plan or is a church plan that has not elected to be governed by ERISA.

Practice Pointer: A client's belief about whether a retirement plan is, or is not governed by ERISA, seldom is a reliable guide. If a CPA has any doubt about whether a plan is governed by ERISA, he or she should not make an "educated guess" or assumption, and instead should urge his or her client to get an employee benefits lawyer's advice.

Moreover, a charitable organization's payroll practice of allowing employees to make completely voluntary salary-reduction contributions to contracts that are intended to get the Federal income tax treatment of Internal Revenue Code Section 403(b) might not be a "plan" at all, at least for ERISA purposes, if the employer does not:

- Make any contribution to the plan;
- Sponsor, endorse, maintain, or administer the plan; or
- Receive any consideration concerning the plan.

Likewise, an employer's payroll practice of allowing employees to make completely voluntary contributions to Individual Retirement Accounts might not be a "plan" if the employer does nothing that would lead an employee to believe that the employer "endorses" the use of IRAs.

Note. If a defendant seeks to dismiss or defend against a lawsuit on the ground that an arrangement the complaint asserts to be an employee benefit plan is not (or was not) a plan, the burden of proof is on the defendant to show that the arrangement is not a plan.

How Does a Person Become a Fiduciary to a Retirement Plan?

Many people are fiduciaries of a retirement plan without even knowing it. The many ways one can become a fiduciary of an employee benefit plan include these:

- A document—which does not have to be a "formal" plan document, and could be just a memo or even an e-mail—names the person (often by a job title) as a plan administrator, plan manager, claims administrator, committee member, trustee, or other fiduciary.

⁶ ERISA § 401(a), 29 USC § 1101(a).

- A person's employer appoints him or her (sometimes by a job title) as a plan administrator, plan manager, claims administrator, committee member, trustee, or other fiduciary.
- A person was not appointed to any position concerning the plan, but participated in a decision about
 - A claim under the plan;
 - How to operate the plan;
 - Selecting anyone who provides services concerning the plan;
 - Getting or using the plan's money, investments, or rights.
- The person explained the plan to someone who could believe that the person is responsible, or that those who are responsible support what the person said.
- The person has power to appoint any fiduciary (or anyone described above).
- The person has power to decide who will have power to appoint a fiduciary.
- The person has not been granted power to appoint a fiduciary, but picked someone to "run the plan".
- The person has power to remove someone who is a fiduciary (or anyone described above).

These are just a few of the many ways that someone who has responsibility for a business or an employer organization can become a fiduciary of a retirement plan.

Practice Pointer: A CPA who performs a personal financial planning engagement for a business owner or executive might invite the client to get an evaluation on whether he or she is a fiduciary of a retirement plan (or any employee benefit plan). An unanticipated liability could wreak havoc on a client's financial plan. Even if not part of an engagement, a helpful suggestion might earn a client's respect and loyalty.

Caution: *ERISA expressly recognizes that an officer, employee, agent, or other representative of an employer or other party in interest may serve as a fiduciary in addition to his or her role with the employer or other party in interest. However, in performing his or her fiduciary duties, a fiduciary must put the plan's interests ahead of all others.*

Plan Administrator

Many employers with a retirement plan assume that the trustee, recordkeeper, and investment providers hired for the plan will administer the plan. Wrong! Because the *plan administrator* "hat" bears fiduciary responsibility (and therefore, potential liability), a service-provider business almost never agrees to serve as plan administrator. Instead, the plan administrator almost always is the employer that sponsors the plan—or a committee (sometimes of as few as one person) appointed by the employer (or under its direction).

Practice Pointer: An ideal in managing risks and liability exposures is for a business' owners and executives to avoid service as a fiduciary to a retirement plan. But a plaintiff's lawyer would allege (often successfully) that those who appoint fiduciaries remain responsible. Sometimes, it is easier to do a task than it is to supervise and correct a less capable person's execution of the task. So with many smaller businesses it might be impractical for the business' owners and executives to avoid fiduciary roles.

Certified Public Accountant

Courts interpreting ERISA's definition of a fiduciary have found that a professional—such as an accountant, actuary, lawyer, or physician—is not a fiduciary as long as he or she does not “cross the line” and do something that is beyond the normal and proper scope of his or her licensed profession or that involves discretion concerning plan assets or a plan decision.

***Caution:** It is not enough for a professional to follow customs. Rather, to steer clear of what later might be characterized as a plan fiduciary function, a professional must act within his or her license and relevant laws. For example, a nonlawyer CPA who gives legal advice—even if it is customary in his or her community for nonlawyers to give legal advice—is no longer acting as a CPA. Worse, a court might find that what the CPA considered “advice”⁷ was instead involvement in the plan's decision making, thus making the CPA a plan fiduciary.*

However, a person who renders investment advice on a retirement plan (including to a participant, beneficiary, or alternate payee) and has any compensation (even indirectly) is a plan fiduciary.

Appointing a Fiduciary

Courts have interpreted ERISA so that appointing a person to serve as a fiduciary is itself a fiduciary function, which the appointing person must perform according to ERISA's prudent-expert standard of care and subject to liability for harm to the retirement plan that results from a breach of that care.

***Caution:** ERISA Section 411 makes it a Federal crime for a person who has been convicted, during the past 13 years, of any of a long list of Federal and State crimes (including several regulatory crimes) to serve as an administrator, fiduciary, officer, trustee, custodian, counsel, agent, employee, or representative of any employee benefit plan. Likewise, such a person must not serve in any capacity that involves making decisions for the plan or any custody or control of any plan asset. Further, even without any role for the plan, a person who has been convicted of any of the crimes must not serve as a consultant, adviser, or service provider to an employee benefit plan.*

ERISA Section 411 also makes it a Federal crime for a person to “permit” the service of a person who has been convicted of any of the crimes. An appointment of a person not knowing that he or she had been convicted is not excluded from the appointing person's crime. Therefore, an appointing person might want to design and use an appropriate criminal background check before deciding an appointment.

In evaluating whether a person would be suitable for service as a fiduciary, an appointing person should consider the candidate's honesty, temperament, intelligence, ability to read complex texts (or ability to listen to those texts being read to him or her), ability to devote sufficient time and attention to the matters to be decided, and any other information relevant to whether the candidate would be likely to act with the required care, skill, prudence, and diligence.

⁷ This description does not reflect the author's view about what the law ought to be. Rather, the author believes that any person should be free to give legal advice.

Practice Pointer: An appointment of a fiduciary is not a one-time matter; rather, it is a continuing duty. An appointing person must, as a prudent-expert fiduciary, “monitor” and review the appointee’s performance of his or her duties. If a careful fiduciary would find that the appointee has not performed according to the fiduciary’s standard of care, a person that has authority to remove the appointee must do so, and must replace him or her with a suitable fiduciary.

What Are a Fiduciary’s Duties?

Although an explanation of the general themes of fiduciary duties could be organized in many different ways, the following overview describes a “ten commandments” of fiduciary duties to a retirement plan:

1. **A fiduciary must administer the plan according to the plan’s documents**, except to the extent that a plan provision is “inconsistent” with ERISA. Ordinarily, a plan administrator (and other plan fiduciaries) must administer a plan according to its written terms. The exception that permits deviations to comply with ERISA does *not* permit a plan fiduciary to disobey a plan provision merely because following it would cause the plan to be tax-disqualified.
2. **A fiduciary must communicate** with the plan’s participants, beneficiaries, and alternate payees—giving them at least the disclosures, notices, account statements, and reports required by ERISA, and any further information that a prudent expert managing a retirement plan should know, and that the participant, beneficiary, or alternate payee needs to protect his or her interests concerning the plan.
3. **A fiduciary must diversify the plan’s assets**, unless under circumstances that it is *clearly* prudent not to do so. For a defined benefit plan, the duty to diversify is almost absolute, because except for a plan’s termination and imminent final distribution, only rarely will a plan’s circumstances make it prudent not to diversify. For an individual account or defined contribution plan that does not provide participant-directed investment, a failure to diversify plan investments to avoid concentration risks and other risks of non-diversified investment will almost always be imprudent. For an individual account plan that provides participant-directed investment, the fiduciary that decides the plan’s investment “menu” must ensure that the menu provides diversified options and a sufficient range of such options to allow a participant to “achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for a participant or beneficiary.”⁸
4. **A fiduciary must segregate the retirement plan’s property**. A fiduciary must separately account for the plan’s money, property, and rights. A fiduciary must use the plan’s investments and other property only for the exclusive purpose of providing retirement benefits to the plan’s participants, beneficiaries, and alternate payees.
5. **A fiduciary must act with undivided loyalty to the plan**, considering only how to benefit the plan, not anyone or anything else. A fiduciary may not use the authority, control, or responsibility afforded him, her, or it as a fiduciary to cause a plan to benefit the fiduciary or a person in which they have an interest, and who could affect the fiduciary’s best judgment in their role as a fiduciary.
6. **A fiduciary must manage the plan’s expenses**. A fiduciary must not incur (or allow the plan, even indirectly, to incur) expenses beyond the proper expenses reasonably needed to administer the plan.

⁸ 29 C.F.R. § 2550.404c-1(b)(3)(i)(B)(3).

7. **A fiduciary must act impartially** concerning the plan's participants, beneficiaries, and alternate payees. For example, even if both decisions would be lawful, a fiduciary must not give one participant (or class or group of participants) a more favorable use of the fiduciary's discretion than is provided by the fiduciary's decisions concerning other participants. A fiduciary does not "play favorites".
8. **A fiduciary must not delegate** his, her, or its fiduciary duty. Although plan documents may provide for *allocating* duties among plan fiduciaries, a fiduciary cannot delegate his, her, or its fiduciary duty. Even if a fiduciary relies heavily on a service provider to perform almost all of the work for a retirement plan task, the fiduciary still must supervise, review, and correct the service provider's work. Also, the plan's named fiduciary must coordinate the work of all other fiduciaries (if any) and all service providers.
9. **A fiduciary must be prudent.** In doing all of the things mentioned above, a fiduciary must act as a knowledgeable and careful person who has experience in managing a retirement plan. A fiduciary who is not himself or herself an expert, must get enough information and advice from experts so that he or she in effect becomes an expert.
10. **A fiduciary must pursue a breach by a co-fiduciary.** If a co-fiduciary breaches his, her, or its duties to the retirement plan, each other fiduciary that knows (or should know) about the breach must persuade the breaching fiduciary to correct the breach and, if the breaching fiduciary does not correct the breach and pay restoration for any harm to the plan, must pursue legal action to remedy the breach.

What Is a Fiduciary's Standard of Care?

Although ERISA's standard of care has been the subject of countless descriptions and explanations, the text of the statute's provision is as follows:

[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of:

- providing benefits to participants and their beneficiaries and
- defraying reasonable expenses of administering the plan,
- with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
- in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [ERISA].⁹

Practitioners and courts have interpreted this provision to require a fiduciary to act as a prudent expert would act.

How Can a Fiduciary Protect Against Liability?

To aid in protecting itself against fiduciary liability, a plan fiduciary should use regular procedures and collect relevant information. Using regular procedures is important because it focuses decision making on the relevant factors and establishes a documented record if the fiduciary decision later is challenged.

⁹ ERISA § 404(a)(1), 29 USC § 1104(a)(1).

The Labor department has stated its view that fiduciary reviews may occur “[a]t reasonable intervals,” and that “[n]o single procedure will be appropriate in all cases; [rather,] the procedure adopted may vary in accordance with the nature of the plan and other facts and all circumstances relevant to the [fiduciary’s] choice of the procedure.”¹⁰ Therefore, in deciding the frequency and scope of fiduciary reviews, a plan fiduciary can and should consider the frequency with which relevant information becomes available and the time and expense involved in obtaining and reviewing that information.

Further, a review might be pointless if the fiduciary lacks expertise. A fiduciary must get expert advice for each relevant subject in which the fiduciary is not, himself or herself, already an expert.

Managing Conflicting Interests

ERISA imposes the highest duty of loyalty, including especially a fiduciary duty to avoid self-dealing. If a fiduciary is faced with the possibility of self-dealing because of his or her relationship with an investment or service provider, ERISA permits that fiduciary to remove himself or herself from that particular decision. This removal is called a *recusal*.

A fiduciary does not participate in a prohibited transaction if the fiduciary absents himself or herself from all consideration of the proposed decision and does not exercise any authority, control, or responsibility concerning the proposed decision.¹¹ In addition to not voting on the proposed decision, the fiduciary should physically absent himself or herself from the meeting (or that portion of the meeting) that considers the proposed decision.¹² To rely on a recusal, it is important that the recused fiduciary avoid any attempt to influence others who retain decision-making authority.¹³

Example. Pat is an owner and the CEO of Prestige Printing Company. The Company sponsors an ERISA-governed 401(k) plan, which has about \$7 million in plan investments. Pat is one of three members of the plan’s committee; the other members also are officers of the Company. At the local golf club, Diane, who is a partner of Cheswyck Investment Counsel LLP, says she heard that the plan is ready to replace its investment manager. Pat confirms that the committee will soon send out a request-for-proposals, in which Cheswyck can be invited to compete. Two weeks later, Bill, a senior lending officer at Borrowers Bank calls Pat and tersely says that “it would be a good thing” if Cheswyck won Prestige’s retirement plan business. Borrowing to update equipment and manage cash flows is a natural part of the printing business, and Prestige has significant debts outstanding with the Bank. Pat wonders whether Diane and other Cheswyck partners also have debts with the Bank.

Pat decides that these conflicts make it impossible for her to participate in the plan’s investment-manager selection. Pat formally recuses herself, announces to the committee members that she has a potential conflict of interest (without saying what it is), instructs the committee’s secretary to record her recusal in the minutes of the meeting, and then leaves the room.

But Pat’s recusal alone is not enough. Even if Pat does not say anything, the committee’s remaining members recognize that they know too much about people and businesses in their community, and that each member’s personal interest in maintaining Pat’s good will and continuing business success for Prestige put them in conflict with the plan. Therefore, the two remaining committee members decide to engage (at the plan’s expense) an independent fiduciary to make the investment-manager selection.

¹⁰ 29 C.F.R. § 2509.75-8, A-FR-17.

¹¹ 29 C.F.R. § 2550.408b-2(f), Example 7.

¹² ERISA Advisory Opinion 84-09A, footnote 2 (Feb. 16, 1984).

¹³ ERISA Advisory Opinion 86-11A (Feb. 27, 1986).

To help avoid an opportunity for inappropriate influence, the engaging fiduciaries do not reveal anything about Prestige's interests or preferences, and the independent fiduciary collects his full fee before he begins work. This fiduciary independently writes a "fresh" request-for-proposals and independently publicizes the RFP. Further, he lives and works in a different city and is unfamiliar with the community that Prestige, Cheswyck, and the Bank belong to. The independent fiduciary has no relationship with any of the candidates.

By turning to an independent fiduciary, the plan benefits from an unconflicted decision, and Pat and Prestige's other officers avoid liability for excise taxes, civil penalties, and criminal punishment.

Recusal can be a better choice than resignation when the fiduciary has a conflict of interest only with one or a few matters and the fiduciary's consideration of other matters is valuable for the benefit of the plan.

Caution: *In the Labor department's view, a recused fiduciary's duties concerning a particular plan decision do not necessarily end because the fiduciary recused himself or herself. Rather, if a recused fiduciary has information that the deciding fiduciaries need to make a prudent decision, the recused fiduciary must provide that information to the deciding fiduciaries.¹⁴ However, the recused fiduciary should provide the deciding fiduciaries with the information in a way that does not interfere with the recusal or otherwise reveal the recused fiduciary's conflict of interest.*

What Should a Fiduciary Do If the Others Make A Decision That Is Imprudent?

Under the earlier common law of trusts, any action by fewer than all the trustees, even though a majority, is void unless the trust document states that the trustees may act by a majority. But the modern trend is that if there are three or more trustees, their powers may be exercised by a majority.¹⁵

When a plan fiduciary is outvoted, resignation, without further action to protect the interests of participants and beneficiaries, generally is not enough to protect the outvoted fiduciary from personal liability.

According to the Labor department,

where a majority of [fiduciaries] appear ready to take action [that] would clearly be contrary to the prudence requirement of [ERISA Section] 404(a)(1)(B) . . . , it is incumbent on the minority [fiduciaries] to take all reasonable and legal steps to prevent the action. Such steps might include preparations to obtain an injunction from a Federal District court . . . , to notify the Labor Department, or to publicize the vote if the decision is to proceed as proposed. If, having taken all reasonable and legal steps to prevent the imprudent action, the minority [fiduciaries] have not succeeded, they will not incur liability for the action of the majority. Mere resignation, however, without taking steps to prevent the imprudent action, will not suffice to avoid liability for the minority [fiduciaries] once they have knowledge that the imprudent action is under consideration.

Likewise, a fiduciary's insistence that his or her "objections and the responses to such objections [if any] be included in the record of the meeting" will not be sufficient to protect the outvoted fiduciary. "[R]esignation by the [fiduciary] as a protest against [a fiduciary] breach will not generally be considered sufficient to discharge the [fiduciary's] positive duty under [ERISA Section] 405(a)(3) to make reasonable efforts under the circumstances to remedy the breach."¹⁶ Arguably, an ERISA plan fiduciary might be protected from liability if the other fiduciaries' breach was not *clearly* a breach. However, when considering whether any decision might be clearly a fiduciary breach, the outvoted fiduciary still must act as a prudent-expert fiduciary.

For a non-ERISA plan, the common law of trusts provides a similar or greater duty. An outvoted trustee remains liable for a cotrustee's breach unless the outvoted trustee takes prudent steps to prevent the other

¹⁴ Department of Labor, Employee Benefits Security Administration, ERISA Information Letter, William Lindsay, Local 25 Int'l. Brotherhood of Elec. Workers (Feb. 23, 2005).

¹⁵ Restatement (Third) of Trusts § 39 (2003); see also Uniform Trust Code § 703a.

¹⁶ 29 C.F.R. § 2509.75-5.

trustees' breach or to compel the other trustees to correct the breach. The outvoted trustee has a right to engage independent legal counsel and (if he or she acts or acted in good faith) a right to have the trust advance or reimburse his or her expenses (including attorneys' fees).

Indemnification Against Liability

A retirement plan cannot exempt a plan fiduciary from liability. ERISA provides that "any provision in an agreement or instrument which [sic] purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under [the fiduciary-responsibility provisions of ERISA] shall be void as against public policy."¹⁷

Note. Although State law might permit a non-ERISA plan or trust to vary fiduciary duties, this has little practical significance because a plan that includes even one employee beyond the owners is an ERISA-governed plan.

ERISA provides that any provision that purports to relieve a fiduciary from responsibility or liability for any responsibility is void. Following this, a plan cannot indemnify a fiduciary. Although an ERISA plan cannot indemnify a fiduciary against his, her, or its fiduciary breach, nothing directly precludes an employer (or any person other than the plan) from indemnifying a plan fiduciary, as long as the employer uses its own money rather than plan assets. However, a fiduciary must consider whether the agreement complies with ERISA's other fiduciary-responsibility provisions and other applicable laws. A court might not enforce an indemnity provision if the court finds that the provision has the effect of setting up an incentive for a fiduciary not to perform his, her, or its duty. Further, notwithstanding any written agreement that purports to provide greater protection, a business organization cannot provide indemnification unless the employee acted in good faith and reasonably believed that he or she acted in (or not opposed to) the best interests of the organization.

A service provider can indemnify a plan against the service provider's errors, but cannot indemnify a plan fiduciary. If a service provider agrees to provide indemnification to an ERISA plan fiduciary, that agreement is a prohibited transaction. A service provider may provide appropriate remedies (used solely to restore the plan's loss or expense) for its breach of its own contract services. Accepting an indemnification agreement from a person dealing with the plan is a breach of the fiduciary's duty of loyalty. A careful fiduciary should adopt and follow written procedures for avoiding self-dealing and conflicts of interest. A plan fiduciary may accept for the use of the plan a service provider's indemnification that restores the plan's loss arising from the service provider's breach of its own contract services.

Using Plan Assets to Pay for Necessary Services

A decision to incur a plan expense must be made solely in the interest of participants (including eligible employees) and beneficiaries (including alternate payees) for the exclusive purpose of providing benefits to them and "defraying reasonable expenses of administering the plan."¹⁸ In providing a statutory prohibited-transaction exemption for service arrangements regarding a plan, ERISA provides that a plan may pay for "services necessary for the establishment or operation of the plan."¹⁹ Interpreting this limited exemption, the Labor department's rule states that "[a] service is necessary for the establishment or operation of a

¹⁷ ERISA § 410(a), 29 USC § 1110(a).

¹⁸ ERISA § 404(a)(1)(A)(ii), 29 USC § 1104(a)(1)(A)(ii). *See also* ERISA § 403, 29 USC § 1103.

¹⁹ ERISA § 408(b)(2), 29 USC § 1108(b)(2).

plan . . . if the service is appropriate and helpful to the plan obtaining the service in carrying out the purposes for which the plan is established or maintained.”²⁰ The rule-making history shows that the word “necessary” is not confined to its strictest sense, but instead is construed or interpreted broadly. Commenting on an earlier proposed rule, several comments advocated that a service be considered “necessary” only if it is essential to plan operation. The Labor and Treasury departments did not adopt the “essential” expression, and instead each final rule describes a necessary service as one that’s *helpful* in carrying out the plan’s purposes.²¹

Thus, a service is necessary if it is *helpful* in carrying out the plan’s purposes. For example, a plan administrator could find that a plan’s purposes include helping participants (including eligible employees) understand the relationship between the amounts of their contributions and the amounts of their account balances, which are their benefits. As explained below, a court ordinarily defers to a plan administrator’s good-faith interpretation of the plan’s purposes.

Paying Fees From Plan Assets

Unless the plan’s documents expressly obligate the employer to pay the plan’s expenses,²² a plan’s administrator has (even without an express authorization in the plan) discretion to cause the plan to pay the plan’s reasonable expenses.²³ A plan’s administrator may engage a service provider that is “appropriate and helpful” in carrying out the plan’s purpose. The provider’s compensation must be no more than reasonable for the service provided.²⁴

As with any service arrangement concerning a retirement plan, an independent plan fiduciary must find that the provider’s fee (including all compensation that indirectly relates to plan assets) is no more than reasonable compensation, and that the overall service arrangement is prudent.

Even if a plan’s documents do not require an employer to do so, ordinarily an employer may pay the expenses of a retirement plan that the employer maintains.²⁵

A plan may buy services for eligible employees, even including those who do not have an account balance or accrued benefit under the plan. A plan fiduciary must incur expenses only for the exclusive purposes of administering the plan and providing benefits to participants and their beneficiaries.²⁶ Although practitioners (and some plan documents) use (or define) the word “participant” to refer to a person who has an account balance, ERISA defines the word *participant* for purposes of Title I of ERISA, which includes Part four’s fiduciary-responsibility provisions.²⁷ Under this definition, a participant includes “any employee or former employee . . . who is *or may* [sic] *become* eligible to receive a [plan] benefit[.]”²⁸ Thus, if an employee is not excluded from participation in the retirement plan and could choose to make deferrals and so become entitled to an account balance, the fact that he or she is eligible makes him or her a participant for ERISA Title I purposes. Therefore, spending plan assets to provide services helpful to the plan regarding those who are eligible

²⁰ 29 C.F.R. § 2550.408b-2(b).

²¹ Information about this rule-making in 1976 and 1977 is available from the author.

²² ERISA requires a plan’s administrator (and every plan fiduciary) to obey the plan’s governing documents. The only exception is a plan provision that is contrary to ERISA. ERISA § 404(a)(1)(D), 29 USC § 1104(a)(1)(D).

²³ ERISA § 404(a)(1)(A)(ii), 29 USC § 1104(a)(1)(A)(ii). See ERISA Advisory Opinions 2001-01A (Jan. 18, 2001), 97-03A (Jan. 23, 1997). See generally RESTATEMENT (THIRD) OF TRUSTS § 38(2) (2003 & 2006 Supp.).

²⁴ ERISA § 408(b)(2), 29 USC § 1108(b)(2); 29 C.F.R. § 2550.408b-2(b).

²⁵ Allowing an employer to pay a plan’s expense could be improper if the employer’s willingness to pay and surrounding circumstances are such that the amount is a bribe or other inappropriate influence that could affect a plan fiduciary’s exercise of his, her, or its best judgment solely in the interests of the plan.

²⁶ ERISA § 404(a)(1)(A)(i)-(ii), 29 USC § 1104(a)(1)(A)(i)-(ii).

²⁷ See ERISA § 3, 29 USC § 1002 (flush language) (“For purposes of this title”).

²⁸ ERISA § 3(7), 29 USC § 1002(7) (emphasis added).

but do not yet have an accrued benefit can sometimes be consistent with administering the plan to provide benefits to participants.

Allocating Plan Expenses

In the Labor department's view, a fiduciary may allocate plan expenses on a pro-rata or a per-capita basis, and may allocate an expense even to the account of an individual who does not use the service involved. When a plan incurs an expense for a service available to eligible employees, including those who do not yet have a plan account, the expense attributable to services for persons who have no plan account necessarily must be borne by others.

Example. A plan administrator's contract with a service provider provides a fee that is the result of \$10 per year (or \$2.50 per quarter) multiplied by the number of persons for whom the service is provided. The service is provided to participants, including eligible employees. Although the plan provides the service to 120 persons, 20 of them are eligible employees who have not yet made a contribution and do not have an account balance. To allocate the provider's \$1,200 annual fee (\$300 for a quarter), the plan administrator charges each individual account \$12 (\$3 per quarter).

Flexibility in Allocating the Plan's Expenses

If a plan's documents do not state a provision for allocating an expense among individual accounts,²⁹ the plan's administrator must decide the expense allocation in its discretion. ERISA provides general fiduciary principles, but generally does not state express rules for how plan expenses may be allocated among an individual-account retirement plan's participants and beneficiaries. Therefore, a plan's administrator has considerable discretion to decide how plan expenses will be allocated among individual accounts. Obeying ERISA duties, a plan fiduciary must be prudent in selecting a method of allocation. Prudence requires at least a process by which the fiduciary considers the competing interests of various classes of the plan's participants and the effects of various allocation methods on those interests.

By-balances vs. By-account

The Labor department's Field Assistance Bulletin on allocating plan expenses among individual accounts expressly recognizes at least the following methods that allocate an expense:

- By account or "per capita," that is, dividing the expense by the number of individual accounts and charging the same amount to each;
- "Pro rata" based on the ratio of an account to be charged to all accounts;
- "By event", for example, charging the expense of processing a particular distribution or loan to the account of the participant, beneficiary, or alternate payee who takes the distribution or loan.

Depending on the plan's facts and circumstances, it is possible for any of these methods to be a legitimate allocation of a plan's expense among individual accounts.

Example. A plan administrator's contract with a service provider provides a fee each quarter of 0.03 percent of the plan's assets. For a quarter, the plan's assets is \$2.5 million, and the fee is \$750. The plan has 100 individual accounts. If the plan's administrator allocates this expense on a by-account basis, each account is charged \$7.50 (or about \$30 per year). But if the plan's administrator allocates this expense on a by-balances

²⁹ If a plan's documents provide an allocation formula for an expense, such a plan provision becomes part of defining the benefit under the plan. ERISA § 404(a)(1)(D), 29 USC § 1104(a)(1)(D).

basis, a participant with a \$10,000 account is charged \$3 per quarter (or about \$12 per year), and a participant with a \$300,000 account is charged \$90 (or about \$360 per year).

In choosing an allocation method, a plan fiduciary should carefully consider the plan's particular facts and circumstances, and put in writing the fiduciary's analysis and reasoning for its choice of allocation method.

Observation. It appears that the Labor department's Bulletin on allocating plan expenses did not consider whether an allocation should be based on the service provider's *cost* of performing or providing a service or the *value* to the plan account in obtaining a service. For example, while the Bulletin suggests auditing as an expense that a fiduciary might allocate on a by-account basis, an argument could be made that a participant who has a \$500,000 account might enjoy more value from an independent auditor's assurance than would be enjoyed by another participant who has only a \$5,000 account. It is also possible that the opposite is so: the \$500,000 account might be an immaterial portion of its owner's wealth and belong to a person who personally retains her accountants and lawyers; conversely, the \$5,000 account might be its owner's life savings and belong to a person who is incapable of checking his account statements and has no practical access to any professional help.

Even if one assumes that "cost" is a key fact to consider and presumes that "base" cost services might fit a by-account charge and "variable" cost services might fit a by-balances charge, a plan fiduciary ordinarily will lack enough knowledge about how a service provider estimates its costs of performing services and doing business.³⁰

By Event

For some kinds of retirement plan events, a plan fiduciary may allocate the plan's expense attributable to a specific event or situation to the individual account that caused the need for the plan to incur the expense. For example, if a court order directed to a retirement plan involves the account of one participant, the plan administrator's reasonable expense for a lawyer's advice about whether the order is a domestic-relation order and a qualified domestic-relations order as a reduction could be an expense that a plan administrator might charge against the individual account involved.

Fiduciary Duties for a Summary Plan Description

Because Congress thought it was unfair to make people read "legalese," ERISA requires a plan's administrator (which, almost always, is the employer or a committee of it) to furnish a summary that explains the important provisions of an employee-benefit plan in "plain language" meant to be understandable for the average participant. This document is called a *summary plan description* (SPD).

Perhaps because of its plain-spoken style and informal appearance, many employers mistakenly assume that the SPD is somehow less "legal" than the formal plan document. That's a big mistake. Just as one knows the reality that many people will not read lengthy legal documents, judges understand that and reason that Congress, by enacting the SPD requirement, must have meant that participants not be expected to read the

³⁰ A CPA's generalized knowledge of cost accounting principles might not be relevant to advising a plan fiduciary about how he, she, or it decides allocations of plan expenses among individual accounts because a retirement plan is not a business operation. Rather, deciding these allocations is somewhat similar to fiduciary or trust accounting.

plan document. So even when the SPD included an express disclaimer saying that the plan controlled over the SPD, courts have held that the SPD is, in practical effect, legally binding.

Practice Pointer: A plan's administrator (concerning a plan or a small business, almost always the employer and officers and employees appointed by it) must make sure that the plan's summary is fully accurate and complete, and very carefully written.

Because the statutory requirement to furnish a proper SPD and a plan fiduciary's general duty to communicate about the retirement plan are part of a plan administrator's fiduciary duties, the plan administrator—and the human beings that perform the plan administrator's function—can be personally liable for harms caused because a summary plan description is inaccurate, incomplete, or not in plain language understandable to an “average” participant.

Caution: Many retirement-service providers include an SPD as part of a “turnkey” package of services. But a service provider that is not a law firm cannot render legal advice, and typically does not give any assurance about the legal sufficiency of the SPD furnished. Even a small-business employer would do better to engage an employee-benefits lawyer, who can support his or her work with real responsibility.

Trusts for a Retirement Plan

If a retirement plan includes any investment other than insurance contracts, the plan sponsor or the plan's named fiduciary must create a plan trust and appoint a plan trustee.³¹

Which Persons Are Eligible To Serve As Trustee?

Under State laws, a natural person (that is, a human being) may serve as a trustee (as long as he or she is an adult and not mentally incapacitated). In many States, a business organization (such as, a corporation, partnership, or limited-liability company) that is not a bank, trust company, or similar financial institution with trust powers may not serve as a trustee. But in some of these States an exception permits a business organization to serve as a trustee of an employee-benefit plan that the organization maintains for its employees.

Choosing a Trustee

Using a trustee that is independent of the employer that maintains a plan provides “checks and balances” that can help avoid or mitigate plan losses that might be difficult to prevent and impractical to mitigate if only the employer (and people subordinate to it) administers the plan and trust. For this reason, a retirement plan that has an opportunity to engage an independent trustee should do so.

Practice Pointer: For a “micro” (under \$5 million in plan assets) retirement plan, a financial-services provider often is unwilling to provide a trustee, even a directed trustee. The fact that many financial-services providers see risks in trusteeships suggests why a practitioner might advise a business owner to avoid serving as a trustee (if it is possible to find a bank or trust company that is willing to serve).

³¹ ERISA § 403, 29 USC § 1103.

Fiduciary Duties of a Trustee

To the extent that a plan trustee is responsible for investment management of plan assets, the trustee is a fiduciary.³² Conversely, if the trust document specifies that the plan trustee is to act according to the direction of another person (for example, the plan administrator), the directed trustee is a fiduciary only for the limited purpose of deciding whether the directions furnished are *proper* directions.³³ A direction is proper only if it is “made in accordance with the terms of the plan” and “not contrary to [ERISA].”³⁴ For a trust not governed by ERISA, most State laws provide that a trustee may follow a directing person’s direction unless the direction is manifestly contrary to the terms of the trust or the direction is a serious breach of a fiduciary duty that the directing person owes to a trust beneficiary other than himself or herself.³⁵

Although ERISA expressly permits allocation of fiduciary duties, some courts have held that there may be situations in which a directed trustee may not rely on the plan administrator’s direction. Likewise, the Labor department has stated its view that a directed trustee sometimes must exercise discretion if the directed trustee knows, should know, or even “has reason to believe” that the named fiduciary’s direction is contrary to the terms of the plan or ERISA.

Also, notwithstanding an allocation of fiduciary duties, some courts have held that a trustee may be required to make reasonable efforts to remedy the known breach of the plan administrator. However, a trustee need not try to remedy a breach if the trustee reasonably finds that the effort would not be effective or if the trustee finds that the expense of pursuing a remedy would very likely be disproportionate to the expected recovery.

Practice Pointer: A bank or trust company, to protect itself against unavoidable risks involved in serving as a trustee often includes in its form of trust agreement a provision that the plan sponsor and all participating employers will indemnify the trustee for any claim other than a claim arising out of the trustee’s failure to follow the plan administrator’s instructions. As long as the indemnity involves the employer’s money (rather than plan assets), a court might enforce such an agreement. An employer that engages a bank or trust company should consider whether it is willing to provide this indemnity.

A trustee’s obligations include at least those provided by the trust agreement. If a trustee is a fiduciary, its fiduciary duties include performing the agreed-on duties at least as carefully, skillfully, prudently, and diligently as an expert trustee would do and meeting any cofiduciary duties to pursue remedies for another fiduciary’s breach. As common sense suggests, if there is more than one trust, a trustee is responsible only for the trust of which it is a trustee.³⁶

Trustee’s Resignation Alone Does Not Escape Any Potential Liability

When confronted with a bad situation that might give rise to harm to the plan, a trustee must be prepared to exercise options other than mere resignation. Because a trustee has an affirmative duty to disclose to the plan’s participants, beneficiaries, and alternate payees information that the trustee knows (or should know) that beneficiaries need to protect their interests, resignation alone might not protect the trustee. Instead, the

³² ERISA § 3(21)(A), 29 USC § 1002(21)(A).

³³ But see *Maniace v. Commerce Bank of Kansas City, N.A.*, 40 F.3d 264 (8th Cir. 1994), cert. denied, 514 U.S. 1111 (1995).

³⁴ ERISA § 403(a), 29 USC § 1103(a).

³⁵ See generally Uniform Trust Code § 808(b); Restatement (Third) of Trusts § 74 (2003).

³⁶ ERISA § 405(b)(3)(A), 29 USC § 1105(b)(3)(A).

trustee must take some kind of protective action, such as petitioning a Federal court for the appointment of a successor trustee, or must furnish advance notice to plan participants and beneficiaries so that they may take action to protect their rights.

Further, if a trustee breaches its trust agreement, the counterparty to that agreement (usually, the plan administrator) or an intended third-party beneficiary of the agreement may pursue remedies for the trustee's contract breach. If only the directing fiduciary breached its duties, a claimant may seek equitable relief. If a breach is not yet complete, a Federal court may enjoin the trustee from acting according to the breaching fiduciary's instruction. If a breach is complete, a Federal court may order a person who knowingly participated in the fiduciary's breach to restore property or money to the plan trust.

Selecting Investments

With a *defined benefit plan*, a plan fiduciary that has any discretion to choose plan investments must do so to manage the risks that investment losses (or insufficient investment returns) would leave the plan unable to pay promised benefits. Even if it is clear that an employer is obligated to pay contributions needed to fund benefits promised by the plan, the fiduciaries still must invest the plan's assets prudent to produce sensible investment returns. If there is a significant risk that an employer would refuse to pay, or become unable to pay a required contribution, a plan fiduciary must consider these risks.

Under an *individual-account plan* or *defined contribution plan*, a participant's benefit is defined by the contributions made together with the investment earnings credited to his or her account. That means that each participant will care about investment results, and might want the right to decide his or her account's investment. Moreover, a plan might require a participant to decide his or her account's investment.

Under ERISA, anyone who has any discretion in doing anything for a retirement plan is a *fiduciary*. A fiduciary must make decisions solely for the purpose of providing retirement benefits to participants and their beneficiaries, and must act with the care, skill, prudence, diligence, and expertise of a person who is familiar with retirement plan matters. The fiduciary is personally liable for any loss (including a missed opportunity for a better investment return) arising from his, her, or its failure to live up to this exacting expert fiduciary standard. Lack of knowledge or expertise does not excuse a fiduciary from meeting these standards, and a fiduciary who lacks expertise must hire a suitable expert.

But ERISA gives a fiduciary relief from liability for poor investment performance that results from the participant's exercise of investment control. Simply put, if a participant makes an investment choice, he or she is responsible for that choice. Under a participant-directed investment plan, the fiduciary is responsible for choosing the "menu" of investment options within which the participant may make choices; but the participant is responsible for her choices within the permitted menu. For the fiduciary to gain the protection of this legal relief, the plan must meet all the detailed requirements of regulations under ERISA § 404(c).

How Should a Fiduciary Select Investments for a Retirement Plan?

If an employer makes available (and does not endorse or maintain) a payroll practice of remitting voluntary payroll-deduction contributions to an Individual Retirement Account not selected by the employer and not held under an employer-sponsored plan, the employer might avoid any selection of investment options.

If an employer maintains an employer-sponsored plan that is not governed by ERISA (for example, a church plan or a governmental plan), the employer must make its investment selection (if any) as a fiduciary under applicable State law.

If an employer maintains an ERISA-governed plan, the employer must make any investment selection as an expert fiduciary under ERISA.

What is a Fiduciary's Investment Responsibility for an ERISA Plan?

Concerning an ERISA-governed plan, the plan's fiduciaries must act solely in the best interest of the plan's participants for the exclusive purpose of providing retirement benefits to participants and their beneficiaries.

ERISA requires that a fiduciary act with the care, skill, prudence, and diligence under the circumstances then prevailing, that a prudent person acting as a fiduciary, familiar with retirement plan matters, would use in the conduct of managing a retirement plan. Although it is not entirely accurate, practitioners often say that a plan fiduciary must act as an expert would. For investment decisions, the ERISA fiduciary standard measures the decisions of plan fiduciaries against the decisions that would be made by experienced investment advisers.

Under ERISA's prudent-expert rule, a fiduciary must make a reasonably careful inquiry into the merits of a particular investment decision. A fiduciary's lack of familiarity with a particular form of investment is not an excuse for making an imprudent investment. If a fiduciary does not have sufficient knowledge to evaluate the merits or soundness of a proposed investment, the fiduciary must obtain expert advice in making the decision. However, the fiduciary must make its own decision using that advice.

A fiduciary need not make the "right" decision; rather, the fiduciary must carefully consider sufficient information. The legal standard considers whether the fiduciary's procedure made a well-informed decision possible. If a fiduciary has diligently investigated the relevant information, a court should not interfere with the fiduciary's judgment. Following this, any review of a fiduciary's decision is based on the circumstances and the review conducted at the time the fiduciary made the decision, and not from the vantage point of "20/20 hindsight."

Investment policy statement

The named plan fiduciary should consider making a written investment policy statement. If the plan provides for participant-directed investment, the statement should specify that the plan fiduciary's policy is to make available a broad range of no fewer than three different diversified investment options that have varying degrees of risk and return and that the selection is intended to enable the participant to achieve a balanced portfolio consistent with modern portfolio theory.

Note. A plan's investment policy statement is likely a document that governs the fiduciary's administration of the plan and so must be furnished to a participant, beneficiary, or alternate payee who requests it.

Following the plan fiduciary's continuing duty, the plan fiduciary should revise or reapprove the investment policy statement each year.

Practice Pointer: An investment policy that states something that the plan's fiduciaries do not really do is more dangerous than no statement at all. A CPA who advises the plan fiduciaries might urge them to consider what evidence they could furnish that would prove that the policy was followed. A CPA who advises claimants against a plan fiduciary often will use an investment policy statement and the fiduciary's failure to follow it as evidence of the fiduciaries' carelessness.

How Should an ERISA Plan Fiduciary Evaluate a Provider's Fees?

A plan fiduciary must discharge its duties with expert prudence solely in the interest of the plan's participants and their beneficiaries. This means that a plan fiduciary that selects investment options or service providers must:

- Establish a careful procedure for selecting investment options or service providers;
- Select investment options that are appropriate for the plan;
- Select service providers that are capable of meeting the plan administrator's needs;
- Decide that fees paid to each investment or service provider are reasonable in light of the scope and quality of services provided; and
- Monitor investment options and service providers once selected to evaluate whether they continue to be sound choices.

A plan fiduciary must be a "smart shopper". A plan fiduciary should consider fees as one of several factors in his, her, or its decision making, but need not always choose the least expensive option, especially if a more expensive option involves more services or better services. Because a plan fiduciary must make its decisions for the benefit of a group rather than any individual, a plan fiduciary often will be unable to accommodate some participants' preferences.

A plan fiduciary is relieved from liability to the extent that a fee applies to a participant's or beneficiary's account because of his or her investment direction. "For example, individual service fees may be charged to a participant for taking a loan from the plan[,] or for executing participant investment directions." Likewise, although some plan investment options might have benefits and charges different from other plan investment options, a plan fiduciary is not responsible for a participant's choice among plan investment options.

Note. As of early 2007, there were, pending in the Federal courts, several ERISA lawsuits asserting that fees and expenses of a retirement plan's investments and services, even if all reasonable in amounts, cannot be reasonable compensation as required by ERISA unless the plan fiduciary understands and approves all indirect sources of compensation to each investment or service provider and fully *discloses* all of these arrangements and their details to the plan's participants, beneficiaries, and alternate payees. For updates about these lawsuits, see www.FiduciaryGuidanceCounsel.com.

Socially-Screened Investments

Whether a fiduciary may choose for a retirement plan socially-screened investments remains a topic of considerable debate. A fiduciary may consider social information in a fiduciary's evaluation of a fund if the fiduciary, in good faith, considers that information as a part of his, her, or its investment analysis and a prudent expert would not find that considering the social information impedes the proper investment analysis. Further, a fiduciary must consider social information if a prudent expert would do so. Conversely, a fiduciary must not consider social information if the information is not truly part of the fiduciary's investment analysis.

For an individual account plan that provides participant-directed investment, a better course might be for a plan fiduciary to seek out socially-screened investment funds as plan investment options, in addition to other prudently selected investment options. Then, the plan's regular provisions for participant-directed investment would result in letting each participant choose whether he or she prefers or disfavors socially-screened investments.

Making Investment Decisions

Steps involved in making retirement plan investment decisions include at least the following:

- Consider full information,
- Get expert advice,
- Consider the advice,
- Make the decision.

Investment information

When making a fiduciary investment selection, a plan fiduciary should obtain and carefully consider every kind of information that it could need to make a fully informed, careful, and expert choice. Of course, this includes getting complete information about every fee, charge, or expense of every investment.

Practice Pointer: A plan fiduciary should consider obtaining at least all of the documents that banking, insurance, securities, or other law requires to be furnished about an investment. Why? A plaintiff might argue that a failure to obtain at least the documents that the law provides for an investor's protection shows an obvious lack of prudence. While many people believe that the "official" documents usually are unhelpful and often "bury" the important information in too much text about information that a decision maker need not consider, a fiduciary's effort to read the portions of a document that are useful might alert him or her to questions that otherwise might not have occurred.

A plan fiduciary should also obtain complete information about the compensation to third persons (such as insurance agents, securities broker-dealers, and other intermediaries) that would result from buying (or continuing) an investment. Even if the fiduciary declines to accept advice from any of those persons, a plan fiduciary must know and approve the compensation of every party in interest regarding the plan.

Some important documents to obtain include:

- The insurance or investment contract;
- The prospectus and statement of additional information or other offering documents for any mutual fund or other investment fund;
- For an investment-advisory service, the disclosure statement (including SEC Form ADV) and the investment-advisory agreement;
- A complete explanation of the ownership of every investment or service provider that the plan would do business with;
- A clear disclosure of any relationship that each provider or intermediary has with each other provider or intermediary (or a written continuing warranty that there is no relationship);
- Complete disclosure of any compensation that any person doing anything, even indirectly, with the plan pays to any other person that would deal with the plan;
- A written continuing warranty that each person that would do anything, even indirectly, regarding the plan has disclosed every conflict of interest or related-party transaction that relates to the plan or any person that would deal with the plan;

- A plain-language description of all charges, fees, penalties, or other adjustments that could be imposed under an investment;
- A written confirmation that there can be no fees other than those already disclosed.

The plan fiduciary should retain all these records, and require updated information when it conducts regular reviews of the plan's investment selection.

Practice Pointer: One way to start uncovering documents is to read those that were furnished to find every reference to other documents. Search for phrases such as “incorporated by reference” and “made a part of,” and search for words such as “acknowledge,” “read,” and “received.”

Prospectus

A fiduciary should carefully read each prospectus. A person who receives a prospectus is deemed to know the information stated by the prospectus. If reading a prospectus and thinking about the information stated by it would cause a person to know that he or she might have a claim against the investment's issuer (or against a broker-dealer), such presumed knowledge “starts the clock” for a statute-of-limitations period.

Participant-Directed Investment

If a retirement plan provides participant-directed investment,³⁷ a plan fiduciary might worry about potential complaints from participants whose investments perform poorly. Following ERISA Section 404(c) gives a fiduciary a way to avoid liability for the consequences of a participant's unwise decisions. ERISA Section 404(c) provides that if participants have control over the investment of their plan accounts, plan fiduciaries will not be responsible for participants' investment decisions. The regulations interpret ERISA Section 404(c) and set requirements a plan must meet to ensure that participants have sufficient control over the investment of their retirement plan accounts to justify shifting legal responsibility to them.

Gaining the Protection of ERISA Section 404(c)

As mentioned above, if a plan that provides for participant-directed investment is governed by ERISA, the plan's fiduciaries may avoid liability for a loss that results from a participant's (or beneficiary's or alternate payee's) investment decisions. This relief from liability can be available only if the plan permits the participant, beneficiary, or alternate payee to exercise control over the investment of his or her plan account. This statute expressly delegates to the Labor department authority to make regulations to define what circumstances mean that an individual “exercises control” over his or her plan account.³⁸ The Labor department has made comprehensive regulations to implement this provision.³⁹ (This chapter refers to those regulations as the “404(c) rules.”) If Congress's delegation was not unconstitutional and the Labor department's rules are at least a plausible interpretation of the statute, a fiduciary can obtain the protection of ERISA Section 404(c) only if the plan met all of the requirements of the rules.

A plan fiduciary need not cause a retirement plan to meet the conditions of the ERISA Section 404(c) rules. If, however, an ERISA-governed plan meets all the requirements of the 404(c) rules, a plan fiduciary should be shielded from liability for losses that result from a participant's investment decisions. A fiduciary

³⁷ A *participant-directed plan* is a plan under which each participant (or beneficiary, or alternate payee) directs investment of his or her plan account within a broad range of options selected by the plan fiduciary.

³⁸ ERISA § 404(c)(1), 29 USC § 1104(c)(1).

³⁹ 29 C.F.R. § 2550.404c-1.

that overrules a participant's investment direction because he, she, or it believes that the direction no longer is prudent cannot rely on the protection of ERISA Section 404(c) concerning the overruled participant.⁴⁰

“Complying” with the 404(c) rules does not mean that a fiduciary is completely absolved of liability. ERISA Section 404(c) can relieve a plan fiduciary from liability for a participant's investment directions—within the choices available. However, unless the plan precludes the plan fiduciary from restricting plan investment options, the plan fiduciary still is responsible for the selection (and periodic monitoring) of an appropriate menu of plan investment choices available to participants. If a plan fiduciary makes any selection of the menu of plan investment options, he, she, or it must act prudently in selecting and reviewing the investment options available for the plan. Also, the plan fiduciary must furnish necessary information to participants and promptly implement their investment instructions.

A plan fiduciary that chooses to provide participant investment education might be responsible for the quality of information given. If the plan fiduciary itself provides information, it is responsible for the accuracy, completeness, and appropriateness of that information.⁴¹ If, instead, a plan fiduciary selects a service provider for participant investment education, the plan fiduciary must make a prudent selection. Further, according to the Labor department's view, a designation (or continuation) of a provider for participant-investment education is itself a fiduciary act.⁴² But if all conditions of the ERISA Section 404(c) rules are met, “neither the designation of a person to provide education nor the designation of a fiduciary to provide investment advice to participants and beneficiaries would, in itself, give rise to fiduciary liability for loss, or with respect to any breach of [fiduciary duties], that is the direct and necessary result of a participant's or beneficiary's exercise of independent control.”⁴³

What is Required to “Comply” with ERISA Section 404(c)?

If a plan provides for participant-directed investment for all or some portion of plan investments and chooses to comply with the ERISA Section 404(c) rules, the plan (or the participant-directed portion of the plan) must meet these basic requirements:

Broad range of investments. A participant must have the right to choose from a “broad range” of at least three diversified investments with varying degrees of risk and return.

Investment information. A participant must receive sufficient information to enable him or her to make informed investment decisions (see below). If the plan passes through voting rights of securities, the participant must receive all proxy voting materials.

Investment changes. A participant must have the right to change investments at least once each quarter or more frequently, and to receive written confirmation of account transactions.

What Constitutes a Broad Range of Investments?

Under ERISA Section 404(c), a participant must have the right to choose from a broad range of at least three “core” diversified investments with varying degrees of risk and return.

A “menu” for participant-directed investment must allow a participant to achieve a balanced portfolio or “a portfolio with aggregate risk and return characteristics appropriate for the participant.”⁴⁴ Likewise, each of

⁴⁰ ERISA Advisory Opinion 96-02A (Feb. 9, 1996).

⁴¹ 29 C.F.R. § 2509.96-1(e); Restatement (Second) of Torts § 552 (1977).

⁴² 29 C.F.R. § 2509.96-1(e).

⁴³ 29 C.F.R. § 2509.96-1(e).

⁴⁴ 29 C.F.R. § 2550.404c-1(b)(3).

the core investments must be such that “when combined with investments in the other alternatives [it] tends to minimize through diversification the overall risk of a participant’s portfolio.”⁴⁵ The regulation is based on modern portfolio theory.⁴⁶

Many employee-benefits practitioners suggest that as a bare minimum, a plan that provides participant-directed investment should have a stock fund, a bond fund, and a money-market fund. In selecting the options to be made available under a participant-directed investment plan, however, plan fiduciaries might ask themselves whether they could accept full legal responsibility for managing plan assets if that plan’s investment universe were limited to the investments proposed to be made available to participants. ERISA Section 404(c) is based on the premise that, under a participant-directed plan, a participant is, in effect, his or her own investment trustee.

At least three of the core investment options must be “look-through” investments, such as mutual funds. A “look-through” investment must be sufficiently diversified.

Plan Communications About Investments

The ERISA Section 404(c) rules require that a participant be furnished with, and have the opportunity to obtain, sufficient information to become able to make informed investment decisions. The 404(c) rules divide that information into two categories:

1. Information that must routinely be furnished to every participant (even if he or she does not want it); and
2. Information that must be furnished upon a participant’s request.

If a plan fiduciary wants relief from responsibility for participants’ investment directions, participants must receive written information, at least for the materials required to be routinely furnished. (The rules do not say whether foreign-language materials must be furnished to a participant who cannot read English, and it is not clear what information, if any, must be provided to a participant who cannot read any language.) Furnishing the required information does not constitute giving investment advice for ERISA purposes.⁴⁷

Investment Information that Must Be Furnished to Every Participant

- To obtain ERISA Section 404(c) relief, the following materials must be furnished to every participant in a participant-directed plan:
- A description⁴⁸ of every investment option available under the plan, including a general description of:
 - The identity of the investment manager,
 - Investment objectives,
 - Risk and return characteristics,

⁴⁵ 29 C.F.R. § 2550.404c-1(b)(3)(i).

⁴⁶ For a summary of the use of modern portfolio theory in trust law, see American Law Institute, Restatement (Third) of Trusts (Prudent Investor Rule) §227(a) (1992).

⁴⁷ ERISA § 3(21)(A), 29 USC § 1002(21)(A); 29 C.F.R. § 2509.96-1(d)(1).

⁴⁸ A document that meets the requirements of a profile prospectus under the Federal securities laws likely meets these requirements of the ERISA Section 404(c) rules. See 17 C.F.R. § 230.498.

- Diversification of assets included in the portfolio, and
- Transaction fees and expenses that affect the participant's account balance (including management and investment advisors' fees, initial or deferred sales charges, and redemption or exchange fees).
- If the investment option is governed by the *Securities Act of 1933*, on the participant's initial investment in that option, a copy of the most recent prospectus provided to the plan.
- The name, address, and telephone number of the plan fiduciary (and, if applicable, the other person designated by the plan fiduciary) responsible for providing information upon request (see below).
- An explanation of when and how participants may give investment instructions, including an explanation of any restrictions on plan investment directions and of any restrictions on transfers to or from an investment option.
- An explanation that the plan provides participant-directed investment under ERISA Section 404(c), thereby relieving fiduciaries of liability for losses that are the result of the participant's investment directions.

Investment Information that Must Be Furnished Upon Request

The plan fiduciary must furnish the following information on request:

- A copy of each prospectus (including any statement of additional information);
- A description of annual operating expenses (such as investment-management fees or administration fees) that reduce the rate of return to the participant's account, and the aggregate amount of such expenses expressed as a percentage of average net assets of the investment option;
- A copy of the financial statements and reports for any or all investment options;
- Information on the value of shares or units in any or all investment options;
- Information on the historical investment performance of any or all investment options, determined net of expenses, on a reasonable and consistent basis.⁴⁹

A participant (or a beneficiary or alternate payee who directs investment of a plan account) may request information for a particular investment option or for all investment options.

In fulfilling these requests for information, the plan fiduciary may use whatever information was most recently furnished to it and need not furnish any information that it does not have. However, a plan fiduciary might have a duty to obtain the information available to it.⁵⁰

A Fiduciary's Duty to Provide Accurate Information

Although not expressly stated in the ERISA Section 404(c) rules, a plan fiduciary's general fiduciary duty to provide accurate and not misleading information and careful communications might require that any communication to participants be made with at least the same degree of expert care as would be used by a person who is an expert in communicating investment information to people who lack knowledge of investment matters.

Practice Pointer: A plan fiduciary should provide plan investment information very carefully and only with experts' advice.

⁴⁹ 29 C.F.R. §2550.404c-1(b)(2)(i)(B)(2).

⁵⁰ ERISA §404(a).

Foreign-Language Investment Materials

A plan administrator should provide foreign-language investment materials for a plan only if it has decided, using expert fiduciary prudence, that the plan's expense is necessary for the administration of the plan. In making such a finding, the plan fiduciary should consider whether some of those who cannot or do not read English also cannot or do not read any language.

Providing Investment Education and Advice

Concerning an ERISA-governed retirement plan that provides participant-directed investment, ERISA does not expressly require a plan fiduciary to give advice to participants. Moreover, the ERISA Section 404(c) rules explicitly state that a plan fiduciary need not provide advice to participants concerning their investment choices. Nonetheless, a plan fiduciary might want to provide a means by which participants can get guidance about investment choices. If so, a plan fiduciary might prefer that such services be performed by a person that is appropriately regulated in that conduct, such as a registered investment adviser.

In the Labor department's view, if a plan fiduciary chooses to engage a service provider for participant investment education, it must use fiduciary diligence and expertise in making or reviewing a selection. A plan fiduciary is not responsible, however, to the extent that the participant selects the education provider.

Should an employer make investment education available? For a plan that provides participant-directed investment, the plan administrator need furnish only the "compulsory" information specified by the rules. But some practitioners believe that investment information is not meaningful for a person who has no background to evaluate that information. A disclosure that a fund might invest in preferred stocks means nothing to a person who does not know what a preferred stock is. A report of a fund's past performance, or a disclosure of an investment manager's assumptions about a fund's risk and return characteristics, is useless to a person who has no method to analyze that information. Even knowing whether a fund invests primarily in stocks or in bonds is irrelevant to a person who does not know what a stock or a bond is or how they differ. While the views of employee-benefits and human-resources practitioners vary widely, most employers make some form of investment education available to participants.

How Can a Fiduciary or Participant Evaluate an Investment Adviser?

Although no regulation can ensure the knowledge or competence of any person, the Federal or State law that applies to a registered investment adviser could help an investor get the information he or she needs to evaluate an investment adviser. For example, the Federal *Investment Advisers Act of 1940* requires a registered investment adviser to deliver a disclosure statement that explains the adviser's methods. The information in the disclosure statement might help an investor decide whether an adviser's methods make sense.

Further, a plan fiduciary that considers whether to approve the availability of an investment adviser's services should carefully evaluate whether the adviser's disclosure information is such that a participant, beneficiary, or alternate payee would understand enough information so that he or she could evaluate the adviser's methods and conflicts of interest.

Procedures for Participant-Directed Investment

A retirement plan that provides participant-directed investment may impose reasonable restrictions on the frequency of investment changes. At a minimum, however, a participant must have the right to make investment changes at least once within any three-month period (for example, a calendar quarter).

Further, a restriction on investment changes is "reasonable" only if "it permits participants . . . to give investment instructions with a frequency [that] is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject." Thus, for especially volatile investment funds, a right to daily instructions might be required.

A participant-directed plan must have procedures for accepting or conveying investment instructions. An ERISA Section 404(c) plan must ensure that a participant has a reasonable opportunity to give investment instructions (in writing or otherwise) to an identified plan fiduciary (or other person designated by the plan fiduciary) that is obligated to comply with those instructions, except when the rules permit refusal of the instruction. Also, a participant must have an opportunity to obtain written confirmation of his or her investment instructions.

Practice Pointer: The named plan fiduciary should make sure that the plan has a procedure for participants, beneficiaries, and alternate payees to request account corrections.

Under the ERISA Section 404(c) rules, a plan fiduciary is relieved of fiduciary responsibility for a particular investment direction only if the participant “affirmatively” gives that investment direction. According to the Labor department, if a participant neglects or refuses to give investment instructions for his or her plan account, the plan fiduciary must invest that participant’s account as a fiduciary. Currently, the fiduciary must decide which investments are appropriate to meet that participant’s retirement needs, and must periodically monitor that participant’s account. But some relief might soon become available under a rule for default investments that was pending when the author submitted this chapter.

If a retirement plan is a plan for contributions to “simple retirement accounts” (see Chapter 3) under Internal Revenue Code Section 408(p), even the absence of a participant’s direction becomes treated as the participant’s exercise of control “one year after the simple retirement account is established.”⁵¹

Caution: *This extra relief from fiduciary responsibility for a participant’s investment can apply only concerning SIMPLE IRAs, and not concerning a SIMPLE 401(k) plan.*

Default Investment Gets Treated as the Participant’s Choice

With plans that provide participant-directed investment, some participants neglect the duty to direct investment. Under some of these plans, a plan fiduciary might choose a default investment that applies to the extent that a participant did not specify his or her investment direction. The plan fiduciary must choose such a default prudently and diligently, as an expert fiduciary would. The relief available for a participant-directed investment does not apply to a default investment.

Under a proposed rule, a participant would be treated as “exercising control” over his or her account under an ERISA-governed plan if amounts are invested according to a default arrangement that meets anticipated Labor department regulations (see below). Of course, any relief based on this deemed control applies only until the participant makes his or her own “affirmative” direction.

To get this relief for a default investment, the plan fiduciary must furnish a plain-language notice that explains the participant’s rights and obligations concerning investment direction, and explains how contributions will be invested in the absence of the participant’s investment direction. The notice must be furnished soon enough (but not too soon) so that the participant has a reasonable time to give his or her own investment direction, and so that the absence of an investment direction would make it reasonable to presume implied consent or non-objection to the default investment. The plan fiduciary must repeat this notice before *every* plan year (until the participant gives an “affirmative” investment direction).

Although a plan fiduciary would be relieved from liability for losses that result from a participant’s deemed control based on a complying default-investment arrangement, the plan fiduciary would remain li-

⁵¹ ERISA § 404(c)(2)(C), 29 USC 1104(c)(2)(C).

able for losses that resulted because it did not choose the default as prudently and diligently as an expert fiduciary would.

Proposed Rule for Default Investments Under Participant-Directed Retirement Plans

On September 27, 2006, the Labor department proposed a rule to provide an ERISA-governed retirement plan's fiduciary some relief from responsibility for deciding exactly how to invest a plan account of a participant, beneficiary, or alternate payee who has not directed investment if the plan provides for investment under a *qualified default investment alternative* and meets several conditions.⁵²

The proposed rule would allow the use of funds customarily described as life-cycle, target-retirement-date, or balanced. Also, it would allow as a default investment an account managed by a registered investment adviser, bank, or insurance company that confirms in writing that it is a plan fiduciary.

Although a plan fiduciary would be relieved from liability for a loss that is the "direct and necessary result" from investing in a *qualified default investment alternative* that met all conditions, a plan fiduciary must select (and regularly monitor) a default fund or manager using expert prudence, care, and diligence. Further, the designating plan fiduciary must satisfy itself that there is no prohibited transaction that would result from using the default funds or manager.

Whether the default is funds or using a manager, a default could ignore all of the participant's preferences and personal circumstances other than his or her age. For example, an asset allocation that's "optimized" under modern portfolio theory knowing only the participant's age and presuming that he or she intends to retire at Social Security normal retirement age could be a qualified default. Under the proposed rule, a plan fiduciary could ignore the possibility, or even a probability, that the participant might draw on his or her retirement savings in the near future rather than at some retirement age.

Although Congress in the Pension Protection Act of 2006 directed the Labor department to issue these regulations by mid-February 2007, as of February 28, 2007 the Labor department had not done so. A fiduciary might argue reasonable reliance on Congress' direction and the proposed rules to defend a default investment made on or after January 1, 2007 and before the effective date of the final regulations.

Investing for a "Lost" Participant

According to the Labor department, a plan administrator may follow a uniform procedure of "overriding" a participant's last investment direction when the participant is missing and his or her investment direction no longer seems prudent to the plan administrator. (It is unclear how a plan administrator decides that an investment direction is no longer prudent for the best interests of a person it cannot locate.) Following such a procedure will not cause a plan to lose protection as an ERISA Section 404(c) plan for participants other than those whose investment directions are "overridden."⁵³ However, when the plan administrator changes the investment of a missing participant's account, it does so under a full fiduciary duty to act as an expert investor in managing that participant's account according to the participant's best interests. Alternatively, there should be no liability for following the participant's last investment direction, even if the participant cannot be located and even if that investment direction seems unwise. As long as the plan administrator met all ERISA Section 404(c) requirements, the plan administrator may rely on the participant's last investment direction.

⁵² Fed. Reg., volume 71, number 187 (September 27, 2006) at pages 56806-56824.

⁵³ ERISA Advisory Opinion 96-02A (Feb. 9, 1996).

Refusing a Participant's Investment Instruction

A plan may refuse to implement a participant's (or beneficiary's or alternate payee's) investment instruction if:

- The responsible plan fiduciary knows that a court decided that the directing person is legally incompetent;
- Following the instruction could result in a loss greater than the directing person's account balance; or
- Following the instruction would result in a prohibited transaction.

Proxy Statements

If a retirement plan that provides participant-directed investment provides that any voting, tender, or similar rights under an investment option are passed through to participants, the plan administrator must furnish to participants any proxy materials provided to the plan, as well as a description of the plan's provisions (if any) relating to the exercise of those rights. Further, if there are any restrictions on the participants' exercise of voting, tender, or similar rights under an investment option, the plan administrator must explain those restrictions.

If such a pass-through is not provided, the plan fiduciary must decide whether to vote investment rights in its discretion or as directed by participants.

In general, the right to vote a security is itself a plan investment. Therefore, the plan fiduciary generally has a fiduciary duty to vote a proxy. Nevertheless, a plan fiduciary need not vote (in the author's view) a proxy if the expense properly chargeable against the plan for services needed to decide the appropriate vote outweighs the benefit that a favorable outcome would provide for the plan.

Communicating About a Blackout

An individual-account plan has a blackout if participants, beneficiaries, or alternate payees are restricted for at least three consecutive business days from giving an investment direction or taking a plan loan or distribution, when such transactions ordinarily would be permitted.⁵⁴ If the restriction is imposed for fewer than three days, it is not a blackout.

Note. Although the regulations do not define the term "business days", it excludes Saturdays, Sundays, and holidays—days on which plan transactions usually would not be processed. Thus, if a plan's customary procedure is to process an instruction received on a holiday on the next business day, the holiday does not count for purposes of the blackout period.

A blackout does not include a restriction that results from:

- Applying securities law
- A regularly scheduled restriction explained in the summary plan description
- A qualified domestic relations order (QDRO)
- The plan's procedure for determining whether a court order is a QDRO
- An act (or failure to act) of a participant, a beneficiary, or alternate payee
- A third person's claim or action "involving the account of an individual participant."

⁵⁴ ERISA § 101(i), 29 USC § 1021(i); 29 C.F.R. § 2520.101-3.

Example. A plan's regular procedure provides that a distribution cannot become payable on a day that is sooner than 15 days after a participant, beneficiary, or alternate payee initiated an address change. This procedure gives the participant and the plan administrator the opportunity to detect, by reading a confirmation, whether someone has impersonated the participant. The procedure imposes a restriction on the distribution, but it does not constitute a blackout.

Blackout Notices

If an individual account retirement plan governed by ERISA will have a blackout, the plan administrator must send affected participants, beneficiaries, and alternate payees a notice explaining the blackout. The most common reason for a blackout is a change in record-keepers. Another reason is a change in the record-keeper's computer system.

A blackout notice must include the following information:

- The reason for the blackout,
- An explanation of each investment and other plan right affected,
- The expected beginning of the blackout,
- The expected ending of the blackout,
- An investment warning (see the following),
- A contact for further information.

A blackout notice may describe the beginning or end (or both) of the blackout period by referring to a calendar week rather than a particular day.

If the ability of participants, beneficiaries, or alternate payees to give investment directions is restricted during the blackout, the blackout notice must warn a recipient that he or she should evaluate the appropriateness of his or her current investment decisions because he or she will not be able to direct investments or diversify assets credited to his or her accounts during the blackout.

The notice must be written in language that can be understood by the average participant.

The blackout regulation includes a model notice. A plan that uses paragraphs 4 and 5A of the model notice in its blackout notice satisfies the requirement to inform plan participants, beneficiaries, and alternate payees that they should evaluate the appropriateness of their current investment decisions in light of their inability to direct their investments or diversify assets credited to their plan account during the blackout. But using the model notice does not provide any assurance concerning the regulation's other requirements. Further, the above requirements meet only the plan administrator's duty under ERISA Section 101(i). A plan fiduciary might have additional duties to communicate information about a blackout that participants, beneficiaries, and alternate payees need to know.

A plan administrator must send a blackout notice to each participant, beneficiary, or alternate payee who could be affected by an inability to give an investment direction or take a loan or distribution.

A plan administrator must furnish the notice at least 30 days (but no more than 60 days) before the blackout begins. An exception might be available if the blackout period is the result of a corporate merger, an acquisition, a divestiture, or similar business transaction. In such a case, the plan administrator must furnish the notice as soon as is "reasonably practicable". Another exception might apply if a plan administrator "documents" its decision that there are unforeseeable or extraordinary circumstances beyond its control or that delaying an action would constitute a breach of its fiduciary duties. Even then, a plan administrator must furnish the blackout notice "as soon as [is] reasonably possible under the circumstances."

Follow-up notices are required if a blackout does not end as scheduled. If there is a change in either the beginning or ending of a blackout, the plan administrator must send another notice to affected participants, beneficiaries, and alternate payees as soon as is “reasonably practicable.” This notice must explain the change in the information furnished in the original (or most recent) blackout notice.

Consequences of Failing to Furnish a Blackout Notice

The potential consequences of failing to furnish a blackout notice include fiduciary liability for investment losses in participants’ accounts, civil penalties, and criminal punishment.

Fiduciary liability. Failing to furnish a required blackout notice is a clear breach of the plan administrator’s fiduciary duties. As mentioned elsewhere in this chapter, ERISA provides that a fiduciary is personally liable to make good losses that result from the fiduciary’s breach. Although it might be difficult to prove causation, some lawyers believe that a participant, beneficiary, or alternate payee could allege that he or she would have made different investment directions had he or she received the proper notice.⁵⁵

Civil penalty. If a plan administrator fails to furnish a required blackout notice, the U.S. Labor department may impose a penalty. The maximum penalty is \$110 per affected participant, beneficiary, or alternate payee multiplied by the number of days that the plan administrator failed to furnish the notice.⁵⁶

Example. Harry’s Beer & Soda has a 401(k) plan with 99 participants. Harry, as plan administrator, changed the plan’s record-keeper. To do this, the plan had a blackout period starting at 4:00 p.m. on Monday, December 31, 2007. The “conversion” and reconciliation are completed in three business days, and the blackout ends at 4:00 p.m. on Friday, January 4, 2008. Harry should have sent a blackout notice no later than December 1, 2007 (30 days before the start of the blackout period). Because Harry did not send a blackout notice, his penalty is \$381,150 ($\$110 \times 99 \times 35$ days).

Criminal punishment. A willful failure to furnish a blackout notice may be punished by a fine up to \$500,000 and up to 10 years’ imprisonment, in addition to punishment for related crimes.⁵⁷

Prompt Contributions

Perhaps especially with smaller businesses, a set of frequently-asked questions is about an employer’s duty to send participant contributions. Although the detailed questions are many, they can be organized around these three general questions:

1. How Promptly Must an Employer Send Participant Contributions?
2. What Are the Consequences of Late Contributions?
3. What May an Employer Do to Repair the Harms of a Late Contribution?

Of course, an employer that gets the first one right will not need to worry about the second and third questions.

⁵⁵ Cf. *King v. National Human Resources Committee*, 218 F.3d 719, 24 Employee Benefits Cases (BNA) 2702 (7th Cir. 2000).

⁵⁶ 29 C.F.R. §2560.502e-5, 7.

⁵⁷ ERISA §501.

How Promptly Must an Employer Send Participant Contributions?

An employer must treat participant contributions as plan assets, and must not allow itself or any person other than the plan to use that money. Also, a fiduciary must invest participant contributions promptly.

According to the Labor department's interpretation, a retirement plan's assets include "amounts that a participant has withheld from his [or her] wages by an employer for contribution to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets."⁵⁸ Under this interpretation, amounts withheld from wages always become plan assets *no later than* "the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash." But an employer may not rely on this outer limit as a "safe harbor"; rather, an amount becomes a plan asset as soon as the employer *can* segregate it from its business assets.

Once an amount becomes a plan's assets, an employer and every fiduciary must act on the idea that the amount no longer is the employer's property, and instead has become the plan's property. Therefore, an employer must segregate participant contributions from the employer's assets. Also, the plan's fiduciaries have a duty to invest the plan's assets. That means delivering the amount to the plan's trustee or insurer, or the trustee's or insurer's agent.

Practice Pointer: Some people believe that it is feasible to segregate participant contributions on payday because an employer necessarily sets aside those amounts (and payroll taxes) to compute employees' net paychecks or direct deposits. Some think it might be okay to send the plan a bank wire or check one business day after payday. In every case, the plan fiduciaries must be prepared to explain what accounting activities made it reasonable to use the time they used.

Because the plan's fiduciaries usually have a duty to invest plan contributions, ordinarily an employer must send contributions for investment as often as it takes reductions from employees' wages. Remember, participant contributions become a retirement plan's assets, and usually must be invested, as soon as the amounts can be segregated from the employer's general assets.

The rule for prompt contributions also applies to participant loan repayments—if the repayments are made through payroll deductions. The Labor department has stated its view that, in the absence of interpretive regulations, participant loan repayments are enough like participant contributions to justify applying the interpretation concerning participant contributions to participant loan repayments. Under that view, an employer must segregate and send loan repayments as soon as it "can reasonably segregate" the loan repayments from its general assets.

What Are the Consequences of Late Contributions?

Failing to invest contributions promptly means a liability to make the retirement plan "whole," and could result in a Labor department civil penalty, a Federal excise tax, and other expenses.

In addition to other punishment, penalties, and taxes, failing to invest plan contributions promptly is a fiduciary breach. A breaching plan fiduciary must restore the plan's losses. A plan's losses include a loss of an opportunity to invest in a way that could have resulted in investment gains (even if most or all of the plan's investments lost value). If it is more, an employer must disgorge any value it had from the use of the money.

⁵⁸ This Labor department interpretation applies for ERISA's disclosure, reporting, and fiduciary-responsibility provisions, and ERISA's and the Internal Revenue Code's prohibited-transaction provisions, but does not apply for some other purposes, including considering whether a person's delay in sending contributions was an ERISA or other Federal crime.

Practice Pointer: Many small businesses usually do not have audited financial statements, and often do not have any financial statements. But if a business presents financial statements, an employer's failure to pay over participant contributions promptly might involve payable for the contributions, actual or contingent liabilities based on the plan's claims, an increase to income taxes,⁵⁹ a contingent liability based on the excise tax⁶⁰ owed to the Internal Revenue Service, and a contingent liability based on the civil penalty that might be assessed by the Labor department. Also, because an employer's failure to pay over an amount that has become a plan asset is a crime under Federal and State laws, such a failure might call into question management's integrity, which might require a CPA to intensify audit or review procedures.

What May an Employer Do to Repair the Harms of a Late Contribution?

If an employer failed to invest or pay over a contribution promptly, there are steps it may take to correct that breach and prohibited transaction. In general, a correction involves paying the contributions, and an amount needed to make each participant's account balance at least as much as it would be if all contributions had been invested promptly.

What Interest Rate Does an Employer Use to Make Good Lost Earnings?

Even if the breaching fiduciary decides not to file for a Labor department no-action letter, employee-benefits lawyers usually suggest that an employer provide a correction described in the Labor department's Voluntary Fiduciary Correction Program. For an explanation of that Program, see Chapter 13, "Plan Correction Programs—EPCRS, VFVP, and DFVC."

Does a correction mean a break on the civil penalty? If a fiduciary completes a full correction as provided by the Voluntary Fiduciary Correction Program and receives a Labor department no-action letter, the Labor department will not assess a civil penalty based on the corrected breach.

Does a correction mean a break on the excise tax? If a fiduciary (1) completes a full correction as provided by the Voluntary Fiduciary Correction Program, (2) gets a Labor department no-action letter, and (3) meets all other conditions of a related Class Exemption, the "late" contribution so corrected is an exempt prohibited transaction, and the disqualified person does not owe a prohibited-transaction excise tax.

Should an employer use the Labor department's Correction Program? Whether it is wise or unwise to file an application for a no-action letter under the Labor department's Voluntary Fiduciary Correction Program is a subject for professional advice. Because the Program is not confidential and can lead to consequences beyond taxes, a CPA should not advise a client about the Program until the CPA is satisfied that the client has received expert advice from an employee-benefits lawyer.

Concerning missing or late contributions, other issues to be considered include:

- Whether a diversion, misuse, failure, or delay in handling a retirement plan's contributions or salary reductions tax-disqualifies the plan.

⁵⁹ FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (June 2006) seems to require accounting for income taxes based on the merits of each tax position, under a hypothetical assumption that each tax position would be examined by the tax authority. Following this, if a business' management believes that the employer's failure to pay over a contribution promptly would, on the merits, tax-disqualify the plan, the business' financial statements must increase the amount for income taxes to the extent that a deduction for plan contributions is not allowed because the plan was not a qualified plan.

⁶⁰ FASB Statement No. 109, *Accounting for Income Taxes* and FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (June 2006) seem to apply regarding an income tax but not an excise tax. It is unclear whether a business' financial statements should include any reference to an excise tax the business owes if the tax authority has not manifested any awareness of the tax owed and the business has decided not to file the excise tax return.

- Whether a diversion, misuse, failure, or delay in handling a retirement plan's contributions or salary reductions is an ERISA crime, another Federal crime, or a State-law crime.
- When an **employer-provided contribution**, including matching, non-elective, profit-sharing, safe-harbor, or other contributions that are not salary-reduction contributions, is treated as plan assets.

The Labor department's interpretation of when a participant contribution becomes plan assets does not apply to other kinds of contributions.

To choose the latest time that an employer may make an employer-provided contribution, consider that:

1. The employer and the plan's fiduciaries must obey the plan's terms,
2. Usually an employer will prefer to make a contribution before it must be tested for coverage and non-discrimination, and
3. An employer that wants a tax deduction for a contribution should make the contribution no later than the employer's Federal income tax return deadline.

For example, to allow enough time for Average Contribution Percentage or "ACP" testing to avoid an excise tax, an employer should pay a matching contribution no later than a month after a plan year's close.

Reporting Late Contributions

An employer and the plan's administrator must report "late" contributions on Form 5500. A line of a financial schedule of Form 5500 asks the following question: "Did the employer fail to transmit to the plan any participant contributions within the time period described in 29 CFR 2510.3-102?" If a report answers Yes on this item, it must report the sum of the contributions that an employer did not send "on time."

If a "late" contribution was a prohibited transaction, the employer or other person involved must file a Form 5330 and pay that return's excise tax.

Further, a fiduciary breach, such as failing to invest contributions promptly, is subject to the Labor department's assessment of a civil penalty. The penalty is 20 percent of the amount recovered from the breaching fiduciary under a court order or a settlement agreement. This civil penalty is reduced by the amount of the prohibited-transaction excise tax.

How a Late Contribution Affects a Plan's Financial Statements

A "late" contribution, especially if the employer has not already restored lost earnings, could affect the plan's financial statements.

Note. A small business' retirement plan that usually does not have audited financial statements (see Chapter 22) probably chose the cash-receipts-and-disbursements method of accounting. If so, a plan administrator accounts for a late contribution (and restoration of the harm done to the plan) when the plan actually receives the money.

In addition to other accounting and auditing standards, the instructions for Form 5500 state that an entry on line 4a should be part of the supplemental schedules of a plan's financial statements.

Records Retention

Several ERISA provisions require a plan's administrator and other fiduciaries to keep records. Based on these requirements and an understanding of ERISA's statute of limitations together with ERISA's disclosure and reporting requirements, many practitioners suggest keeping a record for seven years after the close of the plan year in which the act that is the subject of the record occurred.

A much longer time might make sense for records concerning the investment options of a retirement plan that provides participant-directed investment. Because it might be a long time before all participants retire and receive all payments during retirement, a plan fiduciary might consider keeping its records about selecting the plan's investment "menu," summary plan descriptions, and other investment procedure records until at least six years after the plan is terminated and fully distributed. The plan fiduciary also might keep any required investment information compilations (other than prospectuses) until at least six years after delivery of the last account statement relating to the period during which the investment could have been made.

Resources

Following are various resources you may consider reviewing if you have questions about retirement plan fiduciary duties.

Government Resources

- United States Code, Title 29, Chapter 18—Employee Retirement Income Security Program, Subchapter I—Protection of Employee Benefit Rights (29 USC §§ 1001-1461)
- Code of Federal Regulations, Title 29, Chapter XXV—Employee Benefits Security Administration, Department of Labor (29 C.F.R. §§ 2509.75-2 to 2590.736)
- U.S. Department of Labor Employee Benefits Security Administration
- Class and Individual Prohibited-Transaction Exemptions, ERISA Advisory Opinions, Interpretive Bulletins, Information Letters, Technical Releases, Field Assistance Bulletins
- See <http://www.dol.gov/> and do a search for EBSA

AICPA Resources on Professional Practices

The following resources focus on some professional practices and procedures a CPA should use in presenting suggestions mentioned in this chapter:

- American Institute of Certified Public Accountants (AICPA) www.AICPA.org.
- AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans* (2007).
- Lance Wallach, A CPA's Guide: *The Team Approach to Tax, Financial & Estate Planning*, AICPA (2004).

These publications are available at www.CPA2biz.com.

Resources on Laws Concerning Fiduciary Duties

Although a CPA who is not also a lawyer is unlikely to render specific legal advice about a person's fiduciary duties to a retirement plan, a general background in relevant law might improve a CPA's accounting, auditing, financial planning, and tax services. The following resources focus on broad patterns of laws in the United States.

- American Law Institute, Restatement of the Law of Trusts, Third [partly completed] (2003 and 2006 Supplement) and Second (1959)
- National Conference of Commissioners on Uniform State Laws, Uniform Trust Code (2000)

Chapter 24

Uniformed Services Employment and Re-Employment Rights

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As a result of the military conflicts in Iraq and Afghanistan, many employers have employees who are now returning to employment after serving in the military. A number were reservists called to active and/or training duty; others volunteered to serve in the U.S. armed forces (uniformed services employees). In this regard, an employer who sponsors a tax-qualified retirement plan must extend certain pension benefits and protections to uniformed services employees pursuant to the rules set forth under the Uniformed Services Employment and Re-employment Rights Act of 1994 (USERRA).¹

In general, the benefits and protections afforded under USERRA are designed to prohibit employment discrimination against uniformed services employees in order to encourage such employees to continue their service with the uniformed services. Such protections apply ubiquitously to all employers, including governmental, church, private-sector, small employers, and successor employers (who acquired another company via a merger, acquisition, or consolidation). This chapter discusses the pension and healthcare benefits and protections afforded to uniformed services employees under USERRA.

Overview of USERRA

USERRA was signed into law on October 13, 1994. USERRA clarifies and strengthens the Veterans' Reemployment Rights (VRR) Statute.² USERRA is intended to minimize the disadvantages to an individual that result when that person needs to be absent from his or her civilian employment to serve in this country's *uniformed services*. USERRA makes major improvements in protecting service member rights and benefits by

¹ On October 13, 1994, President Clinton signed USERRA into law. On December 19, 2005, the DOL issued final regulations. (70 FR 75246 and 75313).

² The Act itself can be found in the United States Code at Chapter 43, Part III, Title 38. The Department of Labor has issued a memorandum that clarifies its position on the rights of returning service members to family and medical leave under the Uniformed Services Employment and Reemployment Rights Act (USERRA). That memorandum is available at <http://www.dol.gov/vets/media/fmlarights.pdf>.

clarifying the law and improving enforcement mechanisms. It also provides employees with Department of Labor (DOL) assistance in processing claims. Specifically, USERRA expands the cumulative length of time that an individual may be absent from work for uniformed services' duty and retain reemployment rights. The law is intended to encourage non-career uniformed service so that America can enjoy the protection of those services, staffed by qualified people, while maintaining a balance with the needs of private and public employers who also depend on these same individuals.

USERRA potentially covers every individual in the country who serves in or has served in the uniformed services and applies to all employers in the public and private sectors, including federal employers. The law seeks to ensure that those who serve their country can retain their civilian employment and benefits, and can seek employment free from discrimination because of their service. USERRA provides enhanced protection for disabled veterans, requiring employers to make reasonable efforts to accommodate the disability.

USERRA is administered by the DOL, through the Veterans' Employment and Training Service (VETS). VETS provides assistance to those persons experiencing service-connected problems with their civilian employment and provides information about the Act to employers. VETS also assists veterans who have questions regarding Veterans' Preference.³

USERRA covers members of the uniformed services. Uniformed services means the Armed Forces; the Army National Guard and the Air National Guard when engaged in active duty for training, inactive duty training, or fulltime National Guard duty; the commissioned corps of the Public Health Service; and any other category of persons designated by the President in time of war or national emergency. In addition, service as an intermittent disaster response appointee of the National Disaster Medical System (NDMS) when federally activated or attending authorized training in support of their Federal mission is deemed "service in the uniformed services."⁴

Pension Benefits Under USERRA

In order for a uniformed services employee to receive the protections extended under USERRA, such employee must comply with certain notice and re-employment requirements. In this regard, a uniformed services employee will receive the benefits afforded under USERRA if:

1. Such employee provided reasonable advanced notice of his or her intention to serve in the uniformed services to his or her employer. Although USERRA does not specify what constitutes reasonable notice, the Department of Defense in regulations at 32 CFR 104.6(a)(2)(i)(B) notes the Department "strongly recommends that advance notice to civilian employers be provided at least 30 days prior to departure for uniformed service when it is feasible to do so."
2. The uniformed services employee at issue is released from duty unless the employee is:
 - a. Separated from uniformed service with a dishonorable or bad conduct discharge;
 - b. Separated from uniformed service under other than honorable conditions, as characterized by regulations of the uniformed service;

³ For more information, please visit the Veterans' Preference Advisor. Or contact a local VETS office. See <http://www.dol.gov/vets/aboutvets/contacts/main.htm>.

⁴ 20 CFR § 1002.5(o).

- c. A commissioned officer dismissed as permitted under 10 USC 1161(b) by sentence of a general courtmartial; in commutation of a sentence of a general courtmartial; or, in time of war, by order of the President, or
 - d. A commissioned officer dropped from the rolls under 10 USC 1161(b) due to absence without authority for at least three months; separation by reason of a sentence to confinement adjudged by a courtmartial; or, a sentence to confinement in a Federal or State penitentiary or correctional institution.⁵
3. The cumulative period of such employee's uniformed services leave of absence from employment did not exceed five years.
 4. Such employee reported to work or applied for re-employment with his or her employer in a timely manner after the completion of his or her service in the uniformed services. What constitutes "a timely manner" depends on the employee's period of service in the uniformed services.
 - a. If the period of service is either less than 31 days or any length for the purpose of a fitness examination, the employee must report not later than the beginning of the first full regularly scheduled work period on the first full calendar day following completion of service, plus eight hours.
 - b. If the period of service is more than 30 days but less than 181 days, the employee must submit an application for reemployments (written or verbal) not later than 14 days after completing service.
 - c. If the period of service is more than 180 days, the employee must submit an application for reemployment (written or verbal) not later than 90 days after completing service.⁶

Nevertheless, if re-employment with an employer would be impossible or unreasonable, or result in an undue hardship to the employer, then such employer is not obligated to rehire the uniformed services employee at issue. In addition, if the uniformed services employee's position with the employer was related to a temporary position with no reasonable expectation that such employment would continue indefinitely, then such employer is also not required to hire such uniformed services employee. In this regard, an employer is only required to extend the pension benefits as required under USERRA to a uniformed services employee who is actually re-employed by such employer. Therefore, an employer who sponsors a tax-qualified plan should determine whether a uniformed services employee has satisfied the abovementioned requirements in order to qualify for the USERRA benefits discussed below.⁷

Upon re-employment, if the terms of the plan provide for such benefits or contributions, an employer who sponsors such plan must ensure that a uniformed services employee who meets the qualification requirements receive:

1. Profit-sharing contribution(s) that would have been provided to such employee during his or her period of uniformed service. The employer must fund such contributions within 90 days after the date of reemployment or when plan contributions are normally due for the year in which the service in the uniformed services was performed, whichever is later.^{8,9}

⁵ 20 CFR § 1002.135.

⁶ 20 CFR § 1002.115.

⁷ The application of the qualification requirements is beyond the scope of this article. As such, you should contact your legal and tax advisers to discuss the specific application of such rules if you should rehire a military employee.

⁸ 20 CFR 1002.262(a).

⁹ For purposes of annual limitations on contributions, employer and employee contributions made for periods of military service are subject to the limitations applicable to the year in which the contribution relates and not the year in which such contributions are made. However, re-employed military employees are not entitled to missed allocations that result from any "forfeitures" or "lost earnings" on missed or late contributions that occurred during his or her period of qualified military service.

2. The ability to make 401(k) elective deferral contributions that such employee was unable to make during his or her period of uniformed service (make-up contributions).¹⁰ The uniformed services employee must make his or her make-up contributions within a period of time starting with the date of reemployment and continuing for up to three times the length of the employee's immediate past period of uniformed service, with the repayment period not to exceed five years.¹¹
3. Matching contribution(s) equal to the amount that would have been provided to such uniformed services employee during his or her period of uniformed service in relation to the amount of the actual make-up contributions made by such employee during the contribution period.¹²
4. Credit for vesting purposes with regard to the period in which such uniformed services employee was performing qualified uniformed service.¹³
5. No break in service for the uniformed services employee for the purposes of determining eligibility or vesting under the terms of the plan at issue on account of his or her absence from employment due to qualified uniformed service.¹⁴
6. If permitted by the terms of the plan, the suspension of plan loan repayments with respect to the period during which the uniformed services employee performed qualified uniformed services. Upon reemployment, the uniformed services employee at issue must resume loan repayments with the same or greater frequency with regard to the original amortization schedule for such loan. In addition, the re-employed uniformed services employee must repay the full loan with interest (including interest that accrued during qualified uniformed services leave) by the end of the maximum term of such loan, not including the period of time that such qualified uniformed service was performed.¹⁵

As indicated above, uniformed services employees may be entitled to substantial pension rights and benefits under USERRA. As a result, employers must remember to comply with the rights outlined above if a re-employed uniformed services employee meets the qualification requirements. A failure to provide the above-mentioned rights to such uniformed services employee can jeopardize the tax-qualified status of the plan and result in a USERRA violation. The tax-qualified status of a plan can also be jeopardized if an employer:

1. Improperly affords the USERRA benefits to an employee who is not entitled to receive them, or
2. Provides greater benefits than permitted under USERRA to uniformed services employees entitled to receive such benefits.

Therefore, employers who sponsor a tax-qualified plan should review their pension policies and procedures in order to protect the tax-qualified status of the retirement plan at issue.

Healthcare and COBRA Benefits Under USERRA

Employees who perform services in the uniformed services are also entitled to purchase continued healthcare coverage under their employer's health plan during their period of uniformed service.¹⁶ In this regard, an

¹⁰ Actual deferral percentage (ADP) and actual contribution percentage (ACP) tests do not apply to these contributions either for the plan year to which they relate or the plan year in which they are actually made.

¹¹ 20 CFR § 1002.262(b).

¹² 20 CFR § 1002.262(c).

¹³ 20 CFR § 1002.259.

¹⁴ *Ibid.*

¹⁵ IRC § 414(u)(4) and Reg. 1.72(p)-1, Q&A 9(b) and (c).

¹⁶ 20 CFR 1002.163.

employer must continue to provide uniformed services employees and their dependents with healthcare coverage for a period up to 24 months.¹⁷ This coverage must be provided to a uniformed services employee regardless of whether the employer generally provides healthcare coverage during other leaves of absence, or the employer is subject to the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA). If the employee's absence is less than 31 days, the employer must not charge a uniformed services employee more than the regular employee share for the purposes of maintaining healthcare coverage under the employer's health plan. However, if the employee's absence is 31 days or longer, then an employer may charge a uniformed services employee up to 102 percent of the cost of healthcare coverage.¹⁸

In addition, COBRA integrates the abovementioned healthcare benefits under USERRA with the healthcare benefits afforded under COBRA. In this regard, the healthcare coverage provided under USERRA is treated as an alternative coverage as set forth under COBRA. As a result, the applicable COBRA notices and election rights must be provided to a uniformed services employee when he or she commences a uniformed services leave of absence because such leave constitutes a qualifying event under COBRA due to such employee's reduction of hours with the employer. If the employer is subject to COBRA, then the employer must offer the uniformed services employee with the ability to continue healthcare coverage under USERRA and COBRA. If the uniformed services employee at issue selects USERRA as the form of continuation healthcare coverage, then such person is not entitled to a COBRA election when their healthcare coverage ends under USERRA. If the uniformed services employee selects COBRA as the method of continuation healthcare coverage, then such person may not receive healthcare coverage under USERRA when their healthcare coverage ends under COBRA. Therefore, employers should provide uniformed services employees with the previously mentioned information along with the applicable COBRA materials at the time such employee commences a leave for uniformed service.¹⁹

Required Notice²⁰

Employers are required to disclose the rights, benefits and obligations for both employees and employers under USERRA. The DOL has published two sets of standard disclosures which, if posted where the employer customarily posts notices to employees, is deemed to meet the disclosure requirement. One notice is for private sector and state governmental employers; the other is for Federal executive agencies. The notices are illustrated here. You can find these notices by searching the DOL web site: *www.dol.gov* for USERRA, where they are posted as Adobe PDF files for download.

¹⁷ 20 CFR 1002.164(a)(1).

¹⁸ 20 CFR 1002.166(a) and (b).

¹⁹ 20 CFR 1002.167(b).

²⁰ 20 CFR 1002 Appendix to Part 1002. (A copy of the required poster can be found at http://www.dol.gov/vets/programs/userrra/USERRA_Private.pdf#Non-Federal)



YOUR RIGHTS UNDER USERRA THE UNIFORMED SERVICES EMPLOYMENT AND REEMPLOYMENT RIGHTS ACT

USERRA protects the job rights of individuals who voluntarily or involuntarily leave employment positions to undertake military service or certain types of service in the National Disaster Medical System. USERRA also prohibits employers from discriminating against past and present members of the uniformed services, and applicants to the uniformed services.

REEMPLOYMENT RIGHTS

You have the right to be reemployed in your civilian job if you leave that job to perform service in the uniformed service and:

- ☆ you ensure that your employer receives advance written or verbal notice of your service;
- ☆ you have five years or less of cumulative service in the uniformed services while with that particular employer;
- ☆ you return to work or apply for reemployment in a timely manner after conclusion of service; and
- ☆ you have not been separated from service with a disqualifying discharge or under other than honorable conditions.

If you are eligible to be reemployed, you must be restored to the job and benefits you would have attained if you had not been absent due to military service or, in some cases, a comparable job.

RIGHT TO BE FREE FROM DISCRIMINATION AND RETALIATION

If you:

- ☆ are a past or present member of the uniformed service;
- ☆ have applied for membership in the uniformed service; or
- ☆ are obligated to serve in the uniformed service;

then an employer may not deny you:

- ☆ initial employment;
- ☆ reemployment;
- ☆ retention in employment;
- ☆ promotion; or
- ☆ any benefit of employment

because of this status.

In addition, an employer may not retaliate against anyone assisting in the enforcement of USERRA rights, including testifying or making a statement in connection with a proceeding under USERRA, even if that person has no service connection.

HEALTH INSURANCE PROTECTION

- ☆ If you leave your job to perform military service, you have the right to elect to continue your existing employer-based health plan coverage for you and your dependents for up to 24 months while in the military.
- ☆ Even if you don't elect to continue coverage during your military service, you have the right to be reinstated in your employer's health plan when you are reemployed, generally without any waiting periods or exclusions (e.g., pre-existing condition exclusions) except for service-connected illnesses or injuries.

ENFORCEMENT

- ☆ The U.S. Department of Labor, Veterans Employment and Training Service (VETS) is authorized to investigate and resolve complaints of USERRA violations.
- ☆ For assistance in filing a complaint, or for any other information on USERRA, contact VETS at **1-866-4-USA-DOL** or visit its **website at <http://www.dol.gov/vets>**. An interactive online USERRA Advisor can be viewed at **<http://www.dol.gov/elaws/userra.htm>**. In some cases involving USERRA claims against Federal executive agencies, a complaint filed with VETS before September 30, 2007 may be transferred to the Office of Special Counsel for investigation and resolution pursuant to a demonstration project established under Section 204 of the Veterans Benefits Improvement Act of 2004, Pub. Law No. 108-454 (Dec. 10, 2004).
- ☆ If VETS is unable to resolve a complaint that has not been transferred for investigation under the demonstration project, you may request that your case be referred to the Office of Special Counsel for representation.
- ☆ You may also bypass the VETS process and bring a civil action against an employer for violations of USERRA.

The rights listed here may vary depending on the circumstances. This notice was prepared by VETS, and may be viewed on the internet at this address: <http://www.dol.gov/vets/programs/userra/poster.htm>. Federal law requires employers to notify employees of their rights under USERRA, and employers may meet this requirement by displaying this notice where they customarily place notices for employees.



Office of Special Counsel
202-254-3620



U.S. Department of Labor
1-866-487-2365



1-800-336-4590

Publication Date—January 2006

FOR USE BY PRIVATE SECTOR AND STATE GOVERNMENT EMPLOYERS



YOUR RIGHTS UNDER USERRA

THE UNIFORMED SERVICES EMPLOYMENT AND REEMPLOYMENT RIGHTS ACT

USERRA protects the job rights of individuals who voluntarily or involuntarily leave employment positions to undertake military service or certain types of service in the National Disaster Medical System. USERRA also prohibits employers from discriminating against past and present members of the uniformed services, and applicants to the uniformed services.

REEMPLOYMENT RIGHTS

You have the right to be reemployed in your civilian job if you leave that job to perform service in the uniformed service and:

- ☆ you ensure that your employer receives advance written or verbal notice of your service;
- ☆ you have five years or less of cumulative service in the uniformed services while with that particular employer;
- ☆ you return to work or apply for reemployment in a timely manner after conclusion of service; and
- ☆ you have not been separated from service with a disqualifying discharge or under other than honorable conditions.

If you are eligible to be reemployed, you must be restored to the job and benefits you would have attained if you had not been absent due to military service or, in some cases, a comparable job.

RIGHT TO BE FREE FROM DISCRIMINATION AND RETALIATION

If you:

- ☆ are a past or present member of the uniformed service;
- ☆ have applied for membership in the uniformed service; or
- ☆ are obligated to serve in the uniformed service;

then an employer may not deny you:

- ☆ initial employment;
- ☆ reemployment;
- ☆ retention in employment;
- ☆ promotion; or
- ☆ any benefit of employment

because of this status.

In addition, an employer may not retaliate against anyone assisting in the enforcement of USERRA rights, including testifying or making a statement in connection with a proceeding under USERRA, even if that person has no service connection.

HEALTH INSURANCE PROTECTION

- ☆ If you leave your job to perform military service, you have the right to elect to continue your existing employer-based health plan coverage for you and your dependents for up to 24 months while in the military.
- ☆ Even if you don't elect to continue coverage during your military service, you have the right to be reinstated in your employer's health plan when you are reemployed, generally without any waiting periods or exclusions (e.g., pre-existing condition exclusions) except for service-connected illnesses or injuries.

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- ☆ If you file a complaint with VETS and VETS is unable to resolve it, you may request that your case be referred to the Department of Justice for representation.
- ☆ You may also bypass the VETS process and bring a civil action against an employer for violations of USERRA.

The rights listed here may vary depending on the circumstances. This notice was prepared by VETS, and may be viewed on the internet at this address: <http://www.dol.gov/vets/programs/userra/poster.htm>. Federal law requires employers to notify employees of their rights under USERRA, and employers may meet this requirement by displaying this notice where they customarily place notices for employees.



U.S. Department of Justice



**U.S. Department of Labor
1-866-487-2365**



1-800-336-4590

Publication Date—January 2006

Conclusion

With the prospect of military employees being called to serve in the military in Iraq, Afghanistan, or elsewhere, employers who employ such persons should review their pension and healthcare policies and procedures to ensure compliance under USERRA, maintain the tax-qualified status of the retirement plan at issue, and to accommodate their brave military employees.

Chapter 25

Missing Participants, Beneficiaries, and Alternate Payees

BY DENISE APPLEBY, CISP, CRC, CRSP, CRPS, APA
APPLEBY RETIREMENT CONSULTING INC., MAPLEWOOD, NJ

Locating missing participants can be a costly and time-consuming process. The issue usually becomes a concern for plan administrators and plan fiduciaries when it is time to pay participants, beneficiaries and alternate payees, for reasons including processing mandatory distributions, and providing required notifications. This chapter discusses various methods of locating missing participants, alternate payees under a qualified domestic relations order (QDRO), and beneficiaries; as well as some general procedures. Topics discussed include the Internal Revenue Service (IRS) and Social Security Administration (SSA) letter forwarding programs, the assistance that can be provided by the Pension Benefit Guaranty Corporation (PBGC), as well as Internet and private locator services .

General Rules

In order for a qualified plan to be effectively terminated, assets under the plan must be distributed as soon as administratively feasible, generally, within one year after the plan's termination date.¹ If the plan assets are not distributed within the one year period, the plan would be considered frozen,² instead of terminated, requiring the plan administrator to file Form 5500 returns, and where applicable, perform testing for every year the assets remain in the plan.

Prior to distributions being made from the plan, the plan administrator is required to contact affected participants and beneficiaries and provide information about their distribution options, including rollover and withholding options and rules, as well as to request instructions on how their balances should be distributed. Participants who fail to respond to these requests are considered to be missing (missing participants).

¹ See Rev. Rul. 89-87, 1989-2 C.B. 81.

² Revenue Ruling 89-87.

In instances where participants are missing, plan administrators must determine how they can effectively wind-up the plan's financial affairs, while complying with their fiduciary responsibility to search for missing participants and distribute their benefits.

Plan administrators are required to ensure that the qualified plans they administer operate within requirements as defined by the Internal Revenue Code (IRC), the Employee Retirement Income Security Act of 1974 *as amended* (ERISA) and the governing plan document. Failure to do so may result in the plan losing its qualified status. For instance, a plan must ensure that required minimum distribution (RMD) amounts as defined under IRC § 401(a)(9) are distributed from the plan by the applicable deadlines. Toward that end, certain steps must be taken to locate these RMD eligible participants if they are missing.

If attempts to locate missing participants or beneficiaries are unsuccessful, the plan administrator can seek assistance from the IRS, or the SSA. Special rules apply to a plan covered (insured) by the pension benefit guarantee corporation (PBGC). In addition, there are private firms that provide participant and beneficiary search services. These firms are generally more effective—often 80 to 90 percent effective—than the means that involve using the IRS and the SSA.³ The IRS and SSA programs simply forward letters, and a missing participant who receives a letter may or may not respond, and/or the forwarding area may, in some cases, be limited to one region of the country.⁴

Fiduciary Duties and Missing Participants in Terminated Defined Contribution Plans

On October 1, 2004, the Department of Labor (DOL) issued Field Assistance Bulletin (FAB) 2004-02. In FAB 2004-02, the DOL addressed what a plan fiduciary needs to do in order to fulfill its fiduciary obligations under ERISA with respect to:

- Locating a missing participant of a terminated defined contribution plan; and
- Distributing an account balance when efforts to communicate with a missing participant fail to secure a distribution election.

The following are the key provisions of FAB 2004-02

Fiduciary Responsibilities

A plan fiduciary must act prudently and solely in the interest of the plan participants and beneficiaries for the exclusive purpose of providing benefits, defraying reasonable expenses of administering the plan,⁵ and act in accordance with the documents and other instruments governing the plan.⁶

The steps taken to locate missing participants are governed by the fiduciary responsibility provisions of ERISA and a plan fiduciary's choice of a distribution option is a decision subject to ERISA's general fiduciary responsibility provisions.

A plan fiduciary cannot distribute a missing participant's benefits unless the methods for notifying the participant was followed and proved to be ineffective.

³ Lee, "Tracking Down Missing Beneficiaries," 30 Pension World (Sept 1994) 35.

⁴ Preamble, PBGC Reg. Pt. 4050, 60 Fed. Reg. 61740.

⁵ Section 404(a) of ERISA.

⁶ Section 404(a)(1)(D) of ERISA.

Steps for Locating a Missing Participant

A plan fiduciary must take certain steps in an effort to locate a missing participant or beneficiary before the plan fiduciary determines that the participant cannot be found, and distributes his or her benefits under the plan. These are as follows:

Notifying Participant

The plan fiduciary must notify participants of the fact that the plan is being terminated and of the plan's intention to distribute the assets. The following notification methods are considered adequate:

- ***Certified Mail***, which can be used to easily ascertain whether the participant can be located in order to distribute benefits, at little cost.
- ***Check Related Plan Records***. This includes the records of the qualified plan or the employer's group health plan. If there are privacy concerns, the plan fiduciary that is engaged in the search can request the employer, or other plan fiduciary, to contact or forward a letter on behalf of the terminated plan to the participant or beneficiary, requesting the participant or beneficiary to contact the plan fiduciary.
- ***Check With Designated Plan Beneficiary***. The plan fiduciaries must attempt to identify and contact any individual that the missing participant has designated as a beneficiary (for example, spouse, children) for updated information concerning the location of the missing participant. Again, if there are privacy concerns, the plan fiduciary can request the designated beneficiary to contact or forward a letter on behalf of the terminated plan to the participant, requesting the participant or beneficiary to contact the plan fiduciary.
- ***A Letter-Forwarding Service***. Both the IRS and the SSA offer letter-forwarding services. Plan fiduciaries must choose one service and use it in attempting to locate a missing participant or beneficiary. These are discussed later in this chapter.

These methods are sometimes proven to be inadequate. In the event they are, or if the plan fiduciary has reason to believe that a participant has failed to inform the plan of a change in address, the plan fiduciary needs to take other steps to locate the participant or a beneficiary. These other steps are as follows:

1. Using Internet search tools,
2. Using commercial locator services, and
3. Using credit reporting agencies

Cost Consideration

The plan can pay the cost for these services or charge them to the participant's account. If they will be charged to the participant's account, the size of the account must be considered so as to determine if the method used is appropriate. If the plan balance is a concern, the methods that involve nominal costs must always be used.

Plan Administrative Policy

The plan administrator should consider the adoption of a policy to locate a missing participant and/or alternate payees. The provisions of this policy should be stated in the plan and approved by the IRS. Consideration should be given to the following issues:

- The steps that will be taken to find missing participants.
- What will be done with missing participants' assets under the plan.
- If and when the account value will be forfeited after all reasonable efforts to locate the missing participants or alternate payee have been exhausted and proven unsuccessful.

Note. A plan administrator who follows the appropriate plan procedures for locating a lost participant and/or alternate payee, but is still unable to locate the individual will not violate his or her fiduciary duties by paying the benefits into an interest-bearing federally insured bank account opened in the individual's name. For an administrator to take advantage of this option, the payment option must be permitted under the terms of the plan.

Locating Missing Participants

When a participant or beneficiary is missing, the plan administrator must refer to the plan document for guidance on the actions that must be taken. The following are some general guidelines that can be followed when handling the assets of missing participants.

Cash-Out Provisions

In accordance with the requirements of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Department of Labor issued regulations that qualified plans must follow when the missing participant's balance is \$5,000 or less.⁷

Under these (the cash-out rules), a qualified plan may distribute the balances of missing participants and beneficiaries, without their consent (and the consent of their spouses if applicable). However, this is usually permitted for plan balances of \$5,000 or less.

Automatic Rollover Requirement

If the cash-out balance is between \$1,000 and \$5,000, the amounts must be automatically rolled over to a traditional IRA. The DOL has issued guidance, establishing safe harbor procedure that must be followed in order for the plan to satisfy its fiduciary duties with respect to automatic rollovers.

Practice Pointer: Amounts rolled over by the participant from another retirement plan to the distributing plan may be disregarded for purposes of determining the balance for cash-out purposes.

In order to maintain these safe harbor requirements, the following must occur:

1. The rollover amount must conform with the automatic rollover rules as defined by the DOL/IRS.
2. The rollover must be made to an IRA (individual retirement account or individual retirement annuity).

⁷ IRS Notice 2005-5.

3. The plan administrator must enter into a written agreement with the IRA provider, which provides the following:
 - a. The rolled-over funds will be invested in an investment product designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity.
 - b. The investment product selected for the rolled-over funds will 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 provider.
 - c. The investment product selected for the rolled-over funds will be offered by a State or federally regulated financial institution, which shall be: a bank or savings association, the deposits of which are insured by the Federal Deposit Insurance Corporation; a credit union, an insurance company, an investment company registered under the Investment Company Act of 1940.
 - d. The investments will be designed to minimize risk, preserve assets for retirement and maintain liquidity.
 - e. All fees and expenses, including maintenance fees, investment expenses, termination costs and surrender charges will not exceed the fees and expenses charged by the IRA provider for comparable IRAs established for reasons other than the receipt of an automatic rollover.
 - f. The participant on whose behalf the fiduciary makes an automatic rollover will have the right to enforce the terms of the contractual agreement establishing the IRA, with regard to his or her rolled-over funds, against the IRA provider.
4. Participants must be furnished with a summary plan description (SPD), or a summary of material modifications (SMM), that describes the plan's automatic rollover provisions, including 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, and the name, address, and phone number of a plan contact.
5. Both the fiduciary's selection of an IRA and the investment of funds would not result in a prohibited transaction under section 406 of the Act, unless such actions are exempted from the prohibited transaction provisions by a prohibited transaction exemption issued pursuant to section 408(a) of the Act.⁸

If the cash-out balance is \$1,000 or under, the amount can be paid to the participant or beneficiary.

Practice Pointer: Plans may be amended to reduce the cash-out limit from \$5,000 to \$1,000 or less, thereby negating the need to perform automatic rollovers to IRAs.

Where the balance exceeds \$5,000, the plan document must be consulted for direction on how to handle the assets.

CIP Rule Does Not Apply

The customer identification and verification provision (CIP) of the USA Patriot Act will not apply to IRAs established for the purpose of receiving these involuntary cash-out amounts.

⁸ 29 C.F.R. §2550.404a-2(c).

Forfeiting Balances

The plan document may provide that a missing participant's balance be forfeited, providing the document also includes provisions to restore the forfeited amount plus interest to the participant/beneficiary if he/she makes a subsequent claim for the amount.⁹ In light of the fact that the option of restoring benefits may not be available if the plan sponsor is no longer in business, it is advisable for the plan to use the IRS locating mechanisms, a commercial locator, service or other approved means of locating the participant or beneficiary before electing to forfeit the assets. Some ERISA attorneys also recommend obtaining a determination letter from the IRS, approving this option, before it is implemented under the plan.

Escheating Balances

Plans may include provisions to escheat the balances of missing participants and beneficiaries. State escheat laws should be consulted in order to determine permissible options. The DOL has indicated that this should be done only in the case of terminating plans, as ERISA Sec. 514 preempts state escheat laws.¹⁰ In one example, the DOL held that if the Texas Unclaimed Property Statutes were applied to require the Plan to pay to the State amounts held in the terminated employees' account, or in other accounts of the Plan, such actions would be preempted under section 514(a) of ERISA, and such an application of the State escheat law would directly affect the core functions of the Plan by reducing, through the escheat, the amount of plan assets held in trust for the benefit of all participants and beneficiaries of the Plan.¹¹ Courts have issued opinions that contradict the DOL's position. It is strongly recommended that state law is consulted to determine if and how it interacts with ERISA, and its procedures for handling such accounts. This includes whether it maintains a searchable database of the owners of these assets and the rate of interest that is applied.

Practice Pointer: The transfer of a missing participant's account balance from a terminated defined contribution plan to a state's unclaimed property fund would constitute a plan distribution, which results in the owner no longer being a plan participant and the assets no longer being subject to ERISA.

Annuity Option

Plan administrators may use missing participants and beneficiaries balances to purchase an annuity, if the annuity provider is willing to establish the annuity without the participant's signature. This method is preferable to escheating the assets to the state.

Alternative Arrangements

If a plan fiduciary is unable to locate an IRA provider that is willing to accept a rollover distribution on behalf of a missing participant, plan fiduciaries may consider either establishing an interest-bearing federally insured bank account in the name of the missing participant or beneficiary. Consideration must be given to the interest rate and any applicable fees.

⁹ Treas Reg § 1.411(a)-4(b)(6).

¹⁰ DOL Opinion 94-41A, FAB 2004-02.

¹¹ Advisory Opinion 94-41a.

Tax Withholding and Early Distribution Penalties

With respect to establishing an interest bearing account, or escheating the assets, the plan fiduciary should be aware that the assets will be subject to income taxation, mandatory income tax withholding and a possible additional tax for premature distributions (10 percent early distribution penalty) and the earnings would no longer accrue on a tax-deferred basis.

100 Percent Withholding Not an Option

100 percent income tax withholding on missing participant benefits, which would effect in paying the benefits to the IRS, is not an acceptable means by which to handle the plan benefits of missing participants and beneficiaries, and use of this option would violate ERISA's fiduciary requirements.¹²

IRS Letter Forwarding Program

The IRS will forward letters for third-parties in order to serve humane purposes under its Letter Forwarding Program. IRS Policy Statement P-1-187 established this program, whereby the IRS will forward a letter to an unlocatable individual on behalf of a private individual, company, or government.¹³

Tax returns and return information are considered confidential, as such a party who activates the letter-forwarding service will not be informed of the disposition of the inquiry.¹⁴ Letters intended for individuals for whom the IRS has no current records, and letters forwarded by IRS and then returned as undeliverable, are destroyed without informing the sender of the action taken by the IRS.

Humane Purpose

A *humane purpose* might include an attempt to reunite family members or a qualified plan administrator's attempt to locate and pay a plan participant. The term does not include the reconstruction of a family tree or delivery of a letter seeking reparation.

Example. A qualified plan administrator is attempting to contact a missing participant in regard to the repayment of an overpayment distributed from the plan. The Letter Forwarding Program does not apply to locating a party to pending litigation or for service of process.

Letter Forwarding Procedure

The applicant must provide the IRS with the missing individual's Social Security number, along with other information regarding the search. The IRS will provide assistance in locating 50 or fewer individuals at no cost to the employer. The Letter Forwarding Program is comprised of two components. One involves forwarding letters to 49 or fewer individuals; the other involves forwarding letters to 50 or more individuals. Each option is discussed in the following sections.

¹² FAB 2004-02.

¹³ Rev. Proc. 94-22, 1994-1 CB 608.

¹⁴ IRC Section 6103.

Forwarding Letters to 49 or Fewer Individuals

Procedures for forwarding letters to 49 or fewer individuals within a 12-month period are found in IRS Policy Statement P-1-187. The procedures apply only under certain circumstances. For example, the program can be used if a person is seeking to notify a taxpayer that he or she is entitled to certain assets, for example, from a qualified pension, profit-sharing, or stock bonus plan that has been terminated and from which the taxpayer is entitled to a distribution of benefits. Requests for letter-forwarding assistance involving 49 or fewer participants and beneficiaries are sent to the disclosure officer at the IRS's district office nearest the requester. There is no charge for this service. The following instructions apply to an individual or organization requesting that the IRS forward letters on its behalf to 49 or fewer individuals within a 12-consecutive-month period:

- Prepare a cover letter. This cover letter should state why the assistance of the IRS is being sought, list the name(s), *correct* social security number(s), and (if available) last known address(es) of the individual(s) who cannot be located; and include the name and address of the person or organization to whom the IRS should send an acknowledgment letter.
- Enclosed with the cover letter, include a letter (three pages or less) directed to the individual(s) who cannot be located. This letter should:
 - Advise the recipient of the reason for the letter.
 - Include instructions as to what the recipient should do to contact the sender, if he or she decides to respond.
 - Make clear that a response to the sender's letter is completely voluntary on the part of the recipient.
 - A disclaimer statement. This statement should read as follows:

In accordance with current policy, the IRS has agreed to forward this letter because we do not have your current address. The IRS has not disclosed your address or any other tax information and has no involvement in the matter aside from forwarding this letter. Your response to this letter is completely voluntary.
- A third-party individual or organization requesting the use of the IRS Letter Forwarding Program on behalf of another party that is actually holding assets for a missing taxpayer must:
 - State, in its cover letter to the IRS, that it is acting on behalf of that other party.
 - Present convincing documentation that he or she is acting as the authorized agent of an individual seeking to notify individuals who cannot otherwise be located that they are entitled to certain assets.

In the case of a commercial locator service, written documentation must be provided by the service establishing it as the agent of the person controlling the assets (for example, a letter from the controller of the assets to the IRS, delegating authority to the entity, or a copy of the letter from the controller of the assets to the commercial locator service engaging its services). However, no documentation is necessary if the letter to be forwarded contains instructions to the intended recipient to contact the controller of the assets directly.

Upon receipt of a valid request, the IRS Disclosure Office will search its records under the Social Security number provided and, if an address is found, forward the letter using an IRS envelope. If an address cannot be found or the letter is returned by the postal service as undeliverable, the letter will be destroyed. The requester will not be notified of this action.

Sample Cover Letter to the IRS

Internal Revenue Service
Office of Disclosure
[Address]

To Whom It May Concern:

We hereby request the use of the Internal Revenue Service Letter Forwarding Service. We currently represent the [name of plan or organization], which plan is in the process of being terminated. We are seeking to contact the [number less than 50] individuals listed below, who are entitled to receive a distribution of benefits from the terminated plan, but for whom we do not have addresses.

Enclosed is a list of the names, Social Security numbers, and last known addresses of the individuals we are seeking to contact. Also enclosed is a letter from us, directed to each of the missing individuals, advising each of a right to receive a distribution of plan benefits.

Thanking you in advance for your assistance in this matter

Sincerely,

[Appropriate officer or administrator]

Attachments:

1. List of missing former employees
2. Letters directed to each of the missing former employees

Sample Letter Directed to Missing Participants

[Letterhead with contact information]

[Participant's last known address]

Dear [Participant]:

According to our records, you have a vested benefit in the [name of plan]. This plan is currently in the process of being terminated and will shortly go out of existence. You are entitled to receive a distribution of your accrued benefits in the plan or, if you prefer, you may transfer your assets into another retirement plan of your choice. Once the plan goes out of business, it may become more difficult for you to locate and collect the money to which you are entitled.

In accordance with current policy, the IRS has agreed to forward this letter because we do not have your current address. The IRS has not disclosed your address or any other tax information and has no involvement in the matter aside from forwarding the letter to you. Your response to this letter is completely voluntary.

Please contact us at the address or phone numbers listed above, so we can make arrangements to pay you the money you are owed.

We are looking forward to hearing from you in the near future.

Sincerely,

[Appropriate officer]

Forwarding Letters to 50 or More Individuals

This component of the Letter Forwarding Program, known as the Project 753 Computerized Mail-Out Program, is designed to contact large (that is, more than 50) numbers of missing taxpayers.¹⁵ The following instructions apply to an individual or organization requesting that the IRS forward letters on its behalf to 50 or more individuals.

If the IRS determines that a submission is appropriate for the Letter Forwarding Program, the requester will be contacted with further instructions for forwarding letters to specific individuals. Thus, letters to be forwarded to specific individuals are not to be included in the initial submission.

The requestor should provide the following information:¹⁶

- A brief explanation of the need for letter forwarding
- The number of potential recipients
- Whether the requester has the Social Security number of each individual it wishes to contact on magnetic media specified by the IRS
- A sample of the letter to be forwarded (no more than three pages, front and back, may be used) on the individual's or organization's letterhead and signed by an authorized person
- An estimate of the value of assets being held by the requester for individuals who cannot currently be contacted
- A statement that the requester is aware that IRS will charge a fee for this service

The sample letter should be general in nature and contain the following statement in its opening paragraph, explaining IRS involvement in the Letter Forwarding Program. Do not include Social Security numbers or participant names on the outgoing sample letter:

In accordance with current policy, the Internal Revenue Service (IRS) has agreed to forward this letter because we do not have your current address. The IRS has not disclosed your address or any other tax information and has no involvement in the matter aside from forwarding the letter. Your response to this letter is completely voluntary.

Generally, it will take 90 days from the IRS's acknowledgment of the request before the mailing can be performed. The charge for Project 753 requests is subject to change but currently is approximately \$1,750 plus \$.50 per record. A more precise cost estimate will be given upon request. Actual costs will be billed after completion of the mailing. The IRS will require that the requestor be able to provide the appropriate Social Security numbers on IBM 3490-compatible cartridges, 3.5 inch computer disks, or such other magnetic media as it deems appropriate for the project.

A third-party individual or organization requesting the use of the IRS Letter Forwarding Program on behalf of another party that is actually holding assets for a missing taxpayer must provide additional information. (See the preceding discussion.)

¹⁵ Rev. Proc. 94-22, 1994-1 CB 608.

¹⁶ The request should be forwarded to Internal Revenue Service Director, Office of Governmental Liaison and Disclosure, CL:GLD, Room 1603, Attn.: Irving Porter, 1111 Constitution, Avenue N.W., Washington, D. C. 20224.

Social Security Administration Letter Forwarding Program

The SSA also has a Letter Forwarding Program for advising participants of benefits. The SSA, like the IRS, will not confirm whether the participant has actually received the letter. The lost or missing participant's Social Security number is not required under the SSA Letter Forwarding Program.

The SSA program generally accepts up to 200 letters for forwarding at a charge of \$3 per participant. The letter should contain pertinent information, such as full name, date of birth, and Social Security number, which can be used to locate the individual. Generally, the plan administrator will receive a response within six to eight weeks if the search has been successful.

Plan administrators that want to use the SSA Letter Forwarding Program must follow all of the following procedures:

- Write a cover letter to the SSA explaining the need for letter forwarding (for example, the need to locate a missing participant who is entitled to receive a benefit under a terminating plan).
- Write letters to the missing participants and enclose them in unsealed, unstamped envelopes with the plan administrator's return address.
- Provide as much information as the plan administrator knows about each missing participant, such as name, date of birth, last known address, and Social Security number if any.
- Include a check, payable to the SSA, for the applicable handling fee (\$3 times the number of letters to be forwarded).

Alternatively, if the quantity of letters to be forwarded is large, the plan administrator can seek the assistance of its local SSA office to send its letter-forwarding request to the Office Of Central Office Operations (OCRO).¹⁷

Pension Benefit Guaranty Corporation Missing Participant Programs

The PBGC provides two methods by which a missing participant or beneficiary can be located, which are:

- *PBGC Pension Search Directory.* In an effort to locate missing participants, the PBGC created a *Pension Search Directory*. The directory, which will be updated quarterly, includes the names of people being sought, the names and headquarters locations of the companies where these people earned their pensions, and the date, if any, that the plans terminated. The directory can be found at <http://www.search.pbgc.com>.
- *PBGC Missing Participant Program.* ERISA provides rules for payments of benefits in a standard plan termination to participants whom the plan administrator cannot locate after a diligent search. The regulations establish procedures for the Missing Participants Program that apply to terminating single-employer defined benefit plans.¹⁸ The regulations state that if a plan administrator does not purchase an annuity for a missing participant, the administrator pays the designated benefit to the

¹⁷ For more information, see <http://www.ssa.gov/foia/ltrfwding.htm>

¹⁸ ERISA Section 4050.

PBGC after conducting a diligent search to locate the participant. To qualify as a diligent search, the plan administrator must:

- Begin the search no more than six months before notices of intent to terminate are issued.
- Carry on the search in such a manner that if the participant is found, distribution can reasonably be expected to be made on or before the deemed distribution date.
- Ask any known beneficiaries of the missing participant (including alternate payees) for the missing participant's address.
- Use a commercial locator service.

Other suggested search methods include mailing a letter to the missing participant's last-known address with a request to the post office for an address correction and use of the IRS Letter Forwarding Program. The plan administrator may use additional search methods. However, participants cannot be charged, nor can their benefits be reduced, to cover any search costs.¹⁹ The cost of using a private locator service or any other investigative service is considered an operating expense of the plan.

The selection of an insurance company to provide an annuity must satisfy the same standards used for other participants, as follows:²⁰

- The plan administrator must select the insurer in accordance with the fiduciary standards of Title I of ERISA.
- In the case of a plan in which any residual assets will be distributed to participants, a participating annuity contract may be purchased to satisfy the requirement that annuities be provided by the purchase of irrevocable commitments only if the portion of the price of the contract that is attributable to the participation feature:
 - Is not taken into account in determining the amount of residual assets.
 - Is not paid from residual assets allocable to participants.

Note. Because most insurance carriers will decline to issue an annuity contract without the participant's signature, purchasing an annuity contract may not be a feasible solution. Thus, paying the designated benefit to the PBGC, after a diligent search, may be the only solution.

Private Locator Services

A private (or commercial) locator service is another resource available to plan administrators that need to find missing participants in order to pay them their plan benefits. These services are called private locator services or commercial locator services to distinguish them from the locator services and letter forwarding programs.

Private locator services compile their computer databases from many sources, including state and other government records, such as birth certificates, death certificates, marriage licenses, motor vehicle department registrations, property records, divorce records, voter registration lists, court records, telephone company listings, credit checks, liens, and state limited partnership and corporation filings. The cost of using a private locator service can be outweighed by the advantages of the results it may produce.

¹⁹ PBGC Reg. Section 4050.4(b)(3).

²⁰ See, generally, PBGC Reg. Sections 4041.28(c)(3), 4041.28(c)(4), 4050.3.

Internet Resources

Internet resources are available to plan administrators trying to locate missing participants. Use of Internet resources, however, will not satisfy the PBGC's requirement that the plan administrator use a private locator service, although it may be helpful. A listing of some of the available Internet sites follows:²¹

- *INFO Space* at <http://www.infospace.com>. Once registered, the user can locate missing persons in the United States, Canada, and other countries.
- *Informus Corporation* at <http://www.informus.com/ssnlkup.html>. For a minimal fee, individuals can search Social Security numbers to determine whether a given number is valid. The year and state in which the SSN was issued is provided.
- *Database American Companies-Peoplefinder* at <http://www.database.america.com/html/gpfind.htm>. Residential directory assistance databases are used to search for individuals. Searches are by name or by telephone number, not by address.
- *Ancestry.com* at <http://www.ancestry.com/ssdi/advanced.htm>. The user can link directly to the Social Security Death Index on the Ancestry.com site to locate an individual's death information. Searches can be performed by name, address, Social Security number, birth date, and/or death date.
- *Switchboard* at <http://www.switchboard.com>. Switchboard is a directory that consists of residential and business databases. Searches are by name, city, and state.
- *555-1212.com* at <http://www.555-1212>. This site contains a directory of U.S. telephone numbers covers multiple databases.
- *AnyWho Directory Service* at <http://www.anywho.com>. The user can search for individuals by name, address, state, and telephone number.
- *InfoUSA* at <http://www.abii.com>. InfoUSA uses the American Directory Assistance database to locate individuals by their name, city, and state.
- *Four 11* at <http://www.Four11.com>. Yahoo-sponsored site can be used to locate an e-mail address or telephone number.

²¹ This list was accurate (although by no means exhaustive), at the time of publication. Internet sites are constantly changing and new ones appear every day. For a current listing of locator services, go to Google (www.Google.com) or your favorite search engine and type in "locate missing persons" for additional, current services. Note, however, that not all the sites found will be reputable firms. Due diligence—and common sense—must be employed in determining the validity of a particular service provider.

Chapter 26

Nonqualified Deferred Compensation

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The primary issues that should be addressed with respect to nonqualified deferred compensation plans are:

- 1. Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includable in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.*
- 2. Nonqualified deferred compensation is merely an avoidance of current income taxation, and*
- 3. Control over deferred compensation by an employee for whom the compensation has been deferred (by the employer)—with respect to investment allocation and the distribution of the deferred compensation—creates undesirable dominion and control over deferred compensation.*

This chapter provides a review of the general requirements of Section 409A and the applicable tax principles to address those issues and discusses the design and structure of nonqualified deferred compensation arrangements, in general.

Introduction to Nonqualified Deferred Compensation

The practices of Enron make it clear that executive pay is about more than just tax policy. Executive pay is an issue of corporate governance and accountability, and an issue of fiscal responsibility and fairness. However, it is important to distinguish matters of tax policy from matters of corporate governance and accountability, and from the fiduciary responsibilities related to good corporate governance and accountability.

In considering the practices of Enron regarding executive pay and the tax policies related to nonqualified deferred compensation, it is important to understand the tax rules for executive compensation and how the rules factored into the compensation practices of Enron. The tax law does not specifically encourage executive compensation arrangements. In contrast to qualified retirement plans, Congress has not enacted incentives for companies to maintain executive pay arrangements. The rules on executive compensation generally have

focused on three policy goals: first, to prevent tax avoidance; second, to protect the qualified plan system; and third, to promote good corporate governance.

First, the rules on executive compensation generally are intended to prevent tax avoidance. The general tax principles allow an executive to defer tax on compensation only if the executive accepts the risk that the compensation may never be paid if the company becomes insolvent or bankrupt. Executives typically do not enjoy this risk and seek greater security and control in their deferred compensation arrangements. Second, other rules are intended to protect the integrity of the qualified plan system. To ensure the retirement security of most workers, the tax code provides substantial tax incentives for companies to establish and maintain qualified plans. Allowing executive pay plans to provide the same tax benefits that qualified plans can provide would undermine the qualified plan system. Therefore, the tax code ensures that executive pay arrangements do not inappropriately compete with qualified plans. Third, certain tax rules are intended to promote good corporate governance and accountability. Congress has enacted rules that impose tax penalties unless companies satisfy certain standards.

Nonqualified deferred compensation arrangements, including both executive bonus plans and executive retirement plans, constitute a significant element of executive pay. The objective of these arrangements is to provide tax deferral for a specified period of time on either an elective or non-elective basis. If structured correctly, the tax treatment of a nonqualified deferred compensation arrangement is as follows. The executive does not include the deferred amount in gross income until it is actually paid out to the executive. The company does not claim a deduction for the deferred amount until the executive includes it in gross income. During the deferral period, earnings on the deferred amount generally remain taxable to the company. Therefore, the law imposes a “tax tension” between the executive and the company because every dollar for which the executive defers income is a dollar for which the company must defer its deduction.

The rules of a deduction of the deferred amount are found in IRC Section 404(a). IRC Section 404(a) provides additional guidance regarding the requirements for a deduction for the deferred amount. Under that section, the compensation paid under a plan deferring the receipt of compensation will be deductible only if the compensation otherwise satisfies the requirements for reasonable compensation pursuant to IRC Section 162. The potential loss of a significant tax deduction provides, therefore, a significant incentive to companies to provide only “reasonable” compensation. In addition, the boards of directors of companies have fiduciary obligations under the business judgment rule, a feature of the corporation laws of every state, that require them to assure that deferred compensation pay levels and those for whom such pay levels are established are not abusive to shareholders.

Deferred compensation arrangements must also satisfy certain requirements. First, the executive cannot be in “constructive receipt” of any deferred amount. Section 1.451-2(a) of the Treasury Regulations provides that income is “constructively received” by a cash-basis taxpayer when it is “set apart for him, or otherwise made available so that he may draw upon it at any time,” without “substantial limitations or restrictions.” Under the “doctrine of constructive receipt,” if an individual can elect to receive compensation currently, the individual will be required to pay tax on that compensation currently. However, if the individual’s control over the current receipt of compensation is subject to substantial limitations, then the compensation should not be subject to tax under the constructive receipt doctrine.

This means that an executive can defer an amount only so long as there is a “substantial limitation or restriction” on the right of the executive to receive the amount. The principle of constructive receipt, articulated by the court in *Martin v. C. I. R.*,¹ ensures that an executive may not manipulate the timing of when taxes are due by turning his or her back on income that would be paid currently if the executive requested payment. Accordingly, deferred compensation arrangements typically provide for the deferral

¹ *Martin v. C.I.R.*, 96 T.C. 814, 1991 WL 104315 (1991).

elections to be made before the beginning of the taxable year for which the compensation is earned. The plans generally state the time when amounts will be paid out and the form of the distribution. However, many plans permit an executive to make a subsequent election to defer payouts that are otherwise due, or to change the form of the payout, or both. In the past, plans have required that the subsequent election be made a fixed number of months, generally 12, before the payout is due. Also, prior to IRC Section 409A, plans have permitted accelerated payouts, for example, an early distribution with a “haircut”—such as the forfeiture of 10 percent of the amount of the payout.

Second, the tax law treats an unfunded promise to pay differently from a funded promise. Therefore, the “economic benefit” doctrine and the rules governing transfers of property require that assets related to nonqualified deferred compensation remain subject to the claims of the general creditors of the company along with the other general assets of the company. Under the economic benefit doctrine, an individual is subject to tax currently (even though not necessarily in constructive receipt) if assets are unconditionally and irrevocably paid into a fund or trust to be used for the individual’s sole benefit. Accordingly, as articulated by the court in *C.I.R. v. Smith*,² if an economic or financial benefit is conferred on an individual as compensation in a taxable year, it is taxable to the individual in that year. The general principle of taxing individuals upon the receipt of an economic benefit has been codified in IRC Section 83 with respect to the transfer of property between an employer and an employee.

These rules are intended to put the executive at risk of nonpayment if the company becomes bankrupt or insolvent. If a company insulates deferred compensation assets from the claims of its creditors—for example, by placing the deferred compensation in a trust or an escrow account for the executive to the exclusion of all others—the executive has a taxable economic benefit and must include the deferred compensation in gross income.

Limited funding vehicles have been permitted by the IRS, such as a rabbi trust, without triggering current taxation to the executives. Assets held in a rabbi trust are treated as belonging to the company, and the company continues to pay tax on any income the trust produces, and the assets held in the trust are reachable by the creditors of the company in the event of the insolvency or bankruptcy of the company. However, some arrangements—which, in the past, have included offshore rabbi trusts were established with the intention of protecting the assets held in the arrangements from creditors without triggering current taxation to the executives.

Additionally, the cash-equivalence and assignment of income doctrines require that the interest of the executive in the deferred compensation be nonassignable. This ensures that the executive cannot sell, transfer, pledge, or borrow against the deferred compensation and thereby realize economic value from it before it is paid.

The practices of Enron suggested that the limits of the tax law could be stretched with undesirable consequence without good corporate governance and accountability in the administration and operation of deferred compensation arrangements. As Enron rapidly approached bankruptcy, Enron executives were able to accelerate the distribution of the compensation deferred pursuant to the deferred compensation arrangements. Although the accelerated distributions required a “haircut,” the choice between receiving most of the deferred compensation and, perhaps, receiving none of the deferred compensation was relatively easy. And, if the compensation was distributed sufficiently ahead of the insolvency or bankruptcy of Enron, it would have become difficult to recapture the distributed amounts after the bankruptcy. However, good corporate governance and accountability would, presumably, preserve the integrity of nonqualified deferred compensation arrangements and the purposes of those arrangements and undesirable consequences could be avoided.

² *C.I.R. v Smith*, 324 U.S. 177, 65 S. Ct. 591, 89 L. Ed. 830 (1945), reh. den. 324 U.S. 695, 65 S.Ct. 891, 89 L.Ed. 1295 (1945).

Under the business judgment rule, the structure and administration of nonqualified deferred compensation plans should be governed by the conduct of the board of directors of the employer and the fiduciary duties of care and loyalty owed by the directors to the employer and its shareholders. This conduct may be governed by federal law and state law. In *Buckhorn, Inc. v. Ropak Corp.*,³ Ropak Corporation and Ropak Holdings Corporation sought a preliminary injunction of certain actions taken by Buckhorn, Inc, and its board of directors in response to Ropak's tender offer for any and all shares of Buckhorn stock. Specifically, Ropak sought to enjoin various measures adopted by the board of directors including severance and stock option agreements with six key managers of Buckhorn, Inc. In considering the merits of Ropak's motion, the court noted that Buckhorn, Inc. was a Delaware corporation and, accordingly, the conduct of its directors was governed by Delaware law.

Under Delaware law, the directors of a corporation owe unyielding fiduciary duties of care and loyalty to the corporation and its shareholders. The fiduciary duty of care requires a director to exercise an informed business judgment and to consider all material information reasonably available before making a business judgment.

The court stated that, generally, when reviewing the action of directors, Delaware courts have applied the business judgment rule which presumes that "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Therefore, whether the actions of a corporation's board of directors with respect to issues related to nonqualified deferred compensation plans are taken in the best interests of the corporation may depend upon the standard of conduct required under the business judgment rule and the fiduciary duties of care and loyalty owed by the directors to the corporation and the shareholders of the corporation.

Furthermore, if a court concludes that the terms of a deferred compensation arrangement are so unfavorable to a corporation that no director of ordinary sound business judgment would have voted in favor of it, the arrangement can be invalidated. The term used to describe such a result is "waste" or "gift" of corporate assets. If, in contrast, reasonable persons could disagree whether a compensation arrangement is favorable to the corporation, it could be upheld under the business judgment rule as suggested by the court in *Saxe v. Brady*.⁴

Therefore, in the consideration of the design and the benefits to be provided under a nonqualified deferred compensation plan, the company should determine for the executives the compensation reasonable for the services performed, the compensation necessary to attract and retain the executives, and the structure of a nonqualified deferred compensation plan that would fall within the limits of the fundamental theories and principles of tax law and serve the best interests of the company and its shareholders. The practices of Enron also inspired Congress to give consideration to the design and benefits provided under a nonqualified deferred compensation plan, and on July 25, 2003, the Chairman of the Committee on Ways and Means of the House of Representatives, Bill Thomas, introduced the American Jobs Creation act of 2003. The proposed legislation included provisions that were designed to end abusive income timing and other deferral techniques. The proposed House legislation and the legislation proposed by the Committee on Finance of the United States Senate was eventually passed by the Senate and the House, but not until 2004.

³ *Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio 1987), *aff'd* without opinion 815 F.2d 76 (6th Cir. 1987).

⁴ *Saxe v. Brady*, 40 Del.Ch. 474, 184 A.2d 602, 610 (Del. Ch. 1962).

Section 409A of the Internal Revenue Code

IRC Section 409A was added to the Code by Section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418), effective January 1, 2005, and it applies to compensation deferred after December 31, 2004 (and amounts deferred before that date that have not been “earned and vested” as of December 31, 2004). Section 409A imposes new rules on deferral elections, distributions, and funding mechanisms under nonqualified deferred compensation plans. On December 20, 2004, the Department of the Treasury and the IRS issued much anticipated guidance in the form of Notice 2005-1,⁵ regarding the interpretation and application of certain of the provisions of Section 409A and the amendment and modification of nonqualified deferred compensation plans during a transition period. On October 4, 2005, the Department of the Treasury and the IRS issued Proposed Treasury Regulations regarding the application of Section 409A to nonqualified deferred compensation plans (70 Fed. Reg. 57930). And, on April 17, 2007, the Department of the Treasury and the IRS published Final Treasury Regulations regarding the application of Section 409A to nonqualified deferred compensation plans (72 Fed. Reg. 19234). It is important to determine the impact of the new rules on such plans and the steps that will need to be taken to address the new rules and the guidance issued by the Department of the Treasury and the IRS.

Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includable in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. Significant provisions of Section 409A and the guidance issued by the Department of the Treasury and the IRS are summarized here.

Section 409A provides specific rules for nonqualified deferred compensation plans and failure to comply with those rules generally will result in federal income tax consequences. Pursuant to Notice 2005-1, Q&A-2, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of Section 409A or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includable in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If a deferred amount is required to be included in income under Section 409A, the amount also is subject to interest and an additional penalty. The interest imposed is equal to the interest at the underpayment rate plus one percentage point, imposed on the underpayments that would have occurred had the compensation been includable in income for the taxable year when first deferred or, if later, when not subject to a substantial risk of forfeiture. The additional penalty is equal to 20 percent) of the compensation required to be included in gross income.

The Conference Committee Report, HR4520, dated October 7, 2004, issued in connection with the Act, provides that current income inclusion, interest, and the additional penalty apply only with respect to the participants with respect to whom the requirements of the Act are not met. For example, suppose a plan covering all executives of an employer (including those subject to Section 16(a) of the Securities and Exchange Act of 1934) allows distributions to individuals subject to Section 16(a) upon a distribution event that is not permitted under the Act. The individual subject to Section 16(a), rather than all participants of the plan, would be required to include amounts deferred in income and would be subject to interest and the 20 percent penalty. This is significant since the rule under the Act is to require inclusion of deferred compensation for a tax year and all prior tax years in the taxable income of the participant, plus interest and penalties, if at any time during the tax year the applicable deferred compensation plan fails to satisfy the restrictions specified in the statute. Because the award of deferred compensation under a plan that does not conform to the statute on any day of the service provider’s tax year would require the tax sanctions of the law to be imposed on the

⁵ Notice 2005-1, 2005-2 IRB, December 20, 2004.

service provider, it is incumbent on the employer to have the plan conform to the requirements of the statute no later than the required effective date of the statute.

Furthermore, for certain vested deferred benefits under a supplemental executive retirement plan (a "SERP"), imputed interest could significantly increase the tax penalty for the failure to satisfy Section 409A. For penalty purposes, the plan is comprised of every nonqualified deferred compensation promise of the same type covering the same person. Plan types are defined as account balance (that is, a defined contribution type), nonaccount balance (that is, a defined benefit type), severance plans, and other (for example, equity-based) plans. For example, if a person had a vested deferred benefit under a defined benefit SERP and was also covered under another plan of the same type subject to Section 409A, both plans covering the person are considered the same "plan." The SERP is vulnerable to tax plus imputed interest, plus a 20 percent penalty, if the other plan fails to comply with Section 409A.

Generally, Section 409A, IRS Notice 2005-1, and Section 1.409A-6(a) of the Final Treasury Regulations apply to: (i) amounts deferred in taxable years beginning after December 31, 2004, and (ii) amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. For purposes of determining whether Section 409A is effective with respect to an amount, the amount is considered deferred before January 1, 2005, if: (i) the service provider (generally, a participating employee) had a legally binding right to be paid the amount, and (ii) the right to the amount was "earned and vested." For this purpose, Section 1.409A-6(a)2 of the Final Treasury Regulations, provides that a right to an amount was "earned and vested" only if the amount was not subject to either a substantial risk of forfeiture, as defined in Section 1.83-3(c) of the Treasury Regulations, or a requirement to perform further services. Accordingly, an amount to which an employee does not have a legally binding right before January 1, 2005 (for example, because the employer retains discretion to reduce the amount), will not be considered deferred before January 1, 2005.

Notice 2005-1 and the final regulations make clear, however, that although Section 409A makes a number of fundamental changes, Section 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under Section 409A may nevertheless be required to be included in income under Section 451, the constructive receipt doctrine, the cash equivalency doctrine, Section 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.

Fundamental Doctrines and Theories of Tax

In general, for tax purposes, an unfunded nonqualified deferred compensation plan is one in which a participant in the plan has only the unfunded and unsecured promise of the employer that amounts will be paid when due under the terms of the plan. The employer may maintain separate bookkeeping accounts to reflect the deferred amounts, establish separate bank accounts, purchase assets such as securities or insurance contracts, and even place those assets in grantor trusts, commonly referred to as rabbi trusts, to assist the employer in meeting its liabilities under the plan. The plan is, nevertheless, unfunded so long as those accounts, assets, or trusts are not beyond the reach of the creditors of the employer. On the other hand, funded nonqualified deferred compensation plans are plans in which assets are placed beyond the reach of the creditors of the employer for the exclusive benefit of plan participants. In general, if the obligation of the employer and the rights of an employee are secured in a manner that assures the employee of payment even in the face of the bankruptcy or insolvency of the employer, the plan is a funded plan.

The tax treatment of a nonqualified deferred compensation plan, in large part, is based on many of the fundamental doctrines and theories of income tax that have existed almost from the infancy of the federal tax

system, rather than on specific statutory provisions. These theories and doctrines govern the timing of the recognition of income for the employee of the amounts payable under the deferred compensation plan, and determine the timing for the employer to receive a deduction for the amounts that are payable under the deferred compensation plan.

Prior to 1942, accrual basis employers were generally allowed a current deduction for nonforfeitable liabilities to pay deferred compensation even though the compensation was paid and includable in the income of the employee in a later year.⁶ This mismatching of the employer's deduction and the inclusion in income was eliminated by the Revenue Act of 1942, which added Section 23(p)(1)(D) to the Internal Revenue Code (IRC or the Code) of 1939, the predecessor to Section 404(a)(5) of the IRC of 1986. That provision tied the deduction to the time of payment, but no deduction was allowable for a transfer when taxation was postponed because the transferee's rights were forfeitable. (See Section 1.404(a)-12(c) of the Treasury Regulations.) The Tax Reform Act of 1969 corrected the language in the statute.

IRC Section 404(a) provides that compensation paid under a plan deferring the receipt of that compensation is not deductible under any other section of the Code. However, if it is otherwise deductible under IRC Section 162 (relating to trade or business expenses) or IRC Section 212 (relating to expenses for the production of income) and satisfies the conditions specified in IRC Section 404, it is deductible under IRC Section 404(a). In other words, the compensation must be tested under the reasonable compensation rules of IRC Section 162. With respect to unfunded and funded nonqualified deferred compensation plans, IRC Section 404(a)(5) allows the employer a deduction for compensation paid or contributions made in the taxable year in which "an amount attributable to the contribution is includable in the gross income of employees participating in the plan," provided that "separate accounts are maintained for each employee."

Reasonable Compensation

A nonqualified deferred compensation plan does not satisfy the requirements contained in IRC Section 401(a) and, as a result, does not receive the favorable tax treatment afforded the plans that do satisfy those requirements. Generally, contributions to an unfunded nonqualified deferred compensation plan are not deductible by an employer and are not includable in an employee's income until some future date when the benefits are distributed or made available to the employee. On the other hand, contributions to a funded plan are generally deductible by the employer and includable in an employee's income in the year the contribution is made.⁷

In *Wellons v. Commissioner*,⁸ the court disallowed the taxpayer's deductions for the funding of severance obligations on the basis that the payments made by the taxpayer were to a deferred compensation plan and, therefore, were not deductible. Finding that the plan benefits, which were based on salary and length of service, reflected the characteristics of a deferred compensation plan, the court held that the deduction for contributions to the plan's trust was governed by IRC Section 404(a)(5). Consequently, the contributions were deductible only when benefits were taxable to plan participants on distribution from the trust under IRC Section 404(a)(5).

IRC Section 404(a)(5) provides that an employer can deduct the amounts contributed to a nonqualified deferred compensation plan in the taxable year in which an amount attributable to the contribution is includable in the gross income of employees participating in the plan, but, in the case of a plan in which more

⁶ *Globe-Gazette Printing Co. v. Commissioner*, 16 B.T.A. 161 (1929), acq. IX-1 C.B. 20 (1930).

⁷ IRC Sections 83, 402(b), 404(a)(5), 404(d) and 451; Rev. Rul. 60-31, 1960-1 C.B. 174, 1960 WL 12882, as modified by Rev. Rul. 64-279, 1964-2 C.B. 121, 1964 WL 12635 and Rev. Rul. 70-435, 1970-2 C.B. 100, 1970 WL 20479; Private Ltr. Rul. 9206009, dated November 11, 1991, 9207010, dated November 12, 1991, 9212019, dated December 20, 1991, 9212024, dated December 20, 1991, and 9302017, dated October 15, 1992.

⁸ *Wellons v. Commissioner*, 31 F.3d 569 (7th Cir.1994).

than one employee participates, only if separate accounts are maintained for each employee. IRC Section 404(d) contains a similar rule for the deduction of payments to a plan for independent contractors.⁹ Generally, a deduction is allowed only to the extent of the amount contributed and not the entire amount that is includable in the recipient's income.¹⁰

Section 1.404(a)-12(b)(1) of the Treasury Regulations provides that a deduction is allowable for a contribution under IRC Section 404(a)(5) only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includable in his or her gross income as compensation, and then only to the extent allowable under IRC Section 404(a). For example, if an employer contributes \$1,000 to the account of an employee for its taxable (calendar) year 1977, but the amount in the account attributable to that contribution is not includable in the employee's gross income until the employee's taxable (calendar) year 1980 (at which time the includable amount is \$1,150), the employer's deduction for that contribution is \$1,000 in 1980 (if allowable under IRC Section 404(a)).

In Private Letter Ruling 9212024, dated December 20, 1991, which involved a trust created by an employer to fund benefits under a nonqualified plan, the Internal Revenue Service (IRS) discussed the rules under Section 1.404(a)-12(b)(1) of the Regulations in its analysis of the deduction timing rules. The IRS determined that the employer was entitled to deduct contributions made to the trust that were allocated to the trust accounts of participants in the taxable year in which amounts attributable to those contributions were includable in the gross income of the participants or beneficiaries to the extent such contributions were ordinary and necessary expenses within the meaning of IRC Section 162.

In Private Letter Ruling 9316018, dated January 22, 1993, which involved a secular trust established by an employee, the IRS determined that payments by the employer under the terms of the trust established by the employee were deductible by the employer in the year paid, to the extent the payments were ordinary and necessary expenses within the meaning of IRC Section 162.¹¹

Because a vesting or secular trust is considered to be funded for tax purposes, the employer is entitled to deduct contributions to the trust in the year in which the contributions are made or, if later, the year in which participating employees become vested and, therefore, subject to tax on amounts attributable to those contributions to the extent such contributions are considered ordinary and necessary expenses paid or incurred in carrying on a trade or business. Because the employer cannot be the owner of a vesting or secular trust and the income is taxable to the trust, the employer may not deduct trust income.¹² Thus, the amount of the deduction is equal to the amount of the contribution, which, because of trust earnings, could be less than the entire amount includable in the employee's gross income in accordance with Section 1.404(a)-12(b)(1) of the Treasury Regulations.

Section 1.404(a)-12(b)(2) of the Treasury Regulations provides that if unfunded pensions are paid directly to former employees, such payments are includable in their gross income when paid, and, accordingly, such amounts are deductible under IRC Section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing the employee's salary for a reasonable period), and if such amounts meet the requirements of IRC Section 162 or 212, such amounts are deductible under IRC Section 404(a)(5) in any case when they are not includable under the other paragraphs of IRC Section 404(a).

In Private Letter Ruling 9350018, dated September 17, 1993, which involved a nonqualified plan and a rabbi trust, the IRS stated that IRC Section 404(a)(5) provides the general deduction timing rules applicable

⁹ Treas. Reg. Section 1.404(a)-12(b).

¹⁰ IRC Section 404(a)(5); Treas. Reg. Section 1.404(a)-12(b); Private Ltr. Rul. 9025018, dated March 22, 1990.

¹¹ Private Ltr. Ruling 9417013, dated April 29, 1994, regarding the tax consequences with respect to a vesting trust.

¹² Propose Treas. Reg. Section 1.671-1(g)(1).

to any plan or arrangement for the deferral of compensation, regardless of the Code section under which the amounts might otherwise be deductible. Pursuant to IRC Section 404(a)(5) and Section 1.404(a)-12(b)(2) of the Treasury Regulations, and provided that they otherwise meet the requirements for deductibility amounts of contributions or compensation deferred under a nonqualified plan or arrangement are deductible in the taxable year in which they are paid or made available, whichever is earlier. In another ruling involving a rabbi trust, Private Letter Ruling 9504006, dated October 19, 1994, the employer was entitled to a deduction pursuant to IRC Section 404(a)(5) for amounts paid or made available under the plan and out of the trust only in the taxable year in which the amounts were includable in the gross income of the participant or his beneficiary, provided such amounts otherwise met the requirements for deductibility under IRC Section 162.

Because the rabbi trust is treated as unfunded for tax purposes, the employer is not entitled to deduct the contributions to the trust in the year in which they are made. The employer is generally entitled to a deduction under IRC Section 404(a)(5) in the year the participating employee is subject to tax. The amount of the deduction is the amount contributed to the trust, plus earnings, that is distributed to the employee. Under IRC Section 671, the employer must include all of the income, deductions, and credits of the trust in computing its own taxable income and credits. Thus, the earnings, which are considered an asset of the employer, are treated as contributed or paid by the employer when they are distributed to the employee.

A significant element of IRC Section 404(a)(5) is that, in order to be deductible under IRC Section 404(a)(5) and the regulations thereunder, amounts contributed to a nonqualified plan must also be ordinary and necessary business expenses under IRC Section 162. IRC Section 162(a)(1) allows a deduction with respect to “a reasonable allowance for salaries or other compensation for personal services actually rendered.” Section 1.162-9 of the Income Tax Regulations provides that bonuses paid to employees are deductible “when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered.” Whether an expense that is claimed pursuant to IRC Section 162(a)(1) is reasonable compensation for services rendered is a question of fact that must be decided on the basis of the facts and circumstances. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, pursuant to Section 1.404(a)-1(b) of the Treasury Regulations and Private Letter Ruling 9347012, dated August 18, 1993, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year.

The language in IRC Section 404(a)(5) of the Code provides that contributions under a deferred compensation plan are deductible in the taxable year in which an amount attributable to the contribution is includable in the gross income of an employee participating in the plan. The deduction is matched with the inclusion of income. As Daniel Halperin noted, “in the case of deferred payment of compensation under nonqualified plans, Congress has imposed ‘a matching requirement,’ which denies an employer’s deduction until the deferred amount is included in the employee’s income.”¹³ To allow an employer “to deduct [deferred amounts] prior to their receipt by their employees would contravene the clear purpose of the taxation scheme governing deferred compensation agreements.”¹⁴ This tax tension between the deferral desired by an employee and the current deduction desired by the employer is an inherent limitation on the amount of deferred compensation that a taxable employer would be willing to provide to the employee.

¹³ Daniel I. Halperin, *Interest in Disguise: Taxing the “Time Value of Money,”* 95 *Yale L.J.* 506, 520 (1986) (discussing IRC Section 404).

¹⁴ *Albertson’s Inc. v. Commissioner*, 42 F.3d 537, 546 (9th Cir. 1994), aff’g 95 T.C. 415 (1990).

And, the timing rules governing the recognition of income by an employee are found in the doctrines and theories of constructive receipt, economic benefit, assignment of income, cash equivalency, the transfer of property, and dominion and control. These doctrines and theories impose a standard and structure to deferred compensation plans implemented by employers and promote fair and equitable tax policy.

Constructive Receipt

Generally, contributions pursuant to a nonqualified deferred compensation plan are not includable in a participating employee's income under the constructive receipt doctrine; if the employee's control over the contributions is subject to substantial limitations, then contributions to a nonqualified deferred compensation plan should not be subject to the constructive receipt doctrine. Under IRC Section 451(a) and Section 1.451-1(a) of the Treasury Regulations, a taxpayer includes the amount of any item of gross income in his or her gross income for the taxable year in which he or she receives it, unless, under the taxpayer's method of accounting, it is properly included in a different period.¹⁵

IRC Section 451(a) provides that a taxpayer reporting on the cash method of accounting must include an item in income for the taxable year in which such item is actually or constructively received. Section 1.451-2(a) of the Treasury Regulations defines the term *constructive receipt* as “[i]ncome although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.”

Thus, under the constructive receipt doctrine, a taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment. The doctrine precludes the taxpayer from deliberately turning his back upon income otherwise available.¹⁶

The background for understanding the concept of the constructive receipt doctrine and its application to nonqualified deferred compensation plans is found in several early revenue rulings that applied to certain deferred compensation plans. However, it should be noted that under IRC Section 409A(a)(3), a payment of deferred compensation may not be accelerated (for example, an acceleration of payment only if a financial penalty were imposed or the suspension from participation in the plan) except as provided in the regulations issued by the Department of the Treasury. Certain permissible payment accelerations were listed in Notice 2005-1, Q&A-15, and in Section 1.409A-3(j) of the Final Treasury Regulations.

Revenue Ruling 60-31¹⁷ sets forth the rules of constructive receipt in the area of deferred compensation agreements. This leading ruling in the field of deferred compensation agreements has been sustained by the courts.¹⁸ Revenue Ruling 60-31¹⁹ notes with appropriate authority that “[a] mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intentment of the cash receipts and disbursements method,” and proceeds to review when and under what circumstances certain contractual benefits may be treated as constructively received.

In Revenue Ruling 71-332,²⁰ a profit-sharing plan provided that a participant could withdraw any part of his vested account balance, prior to termination of employment, in the case of financial need but only to the

¹⁵ See Private Ltr. Rul. 9505012, dated November 4, 1994.

¹⁶ *George C. Martin v. Commissioner*, 96 T.C. 814, 1991 WL 104315 (1991).

¹⁷ Rev. Rul. 60-31, 1960-1 C.B. 174.

¹⁸ See *Goldsmith v. United States*, 586 F.2d 810, 815-18, 218 Ct.Cl. 387 (1978).

¹⁹ Rev. Rul. 60-31, 1960-1 C.B. 174.

²⁰ Rev. Rul. 71-332, 1971-2 C.B. 210.

extent approved by the plan's administrative committee. Any participant who desired to make such a withdrawal was required to make a written application to the committee. The committee had the sole discretion to determine whether financial necessity existed and, if so, what portion of the participant's vested account balance could be withdrawn. The plan also provided that, in approving withdrawals, the committee was required to follow a uniform and nondiscriminatory policy.

Example. An employee whose vested account balance was \$3,000 made application for a withdrawal of \$500 because of a financial need. The committee subsequently approved the application for withdrawal both as to need and as to amount. However, the employee later found that he could relieve his financial need by withdrawing only \$400 and only that amount was actually withdrawn.

The IRS found that although the employee could have applied for a withdrawal of the entire vested account balance of \$3,000, he was not considered to be in constructive receipt of that amount since the requirement in the plan for substantiating financial need, obtaining approval of the administrative committee, and the acceptance of whatever terms and conditions such committee could impose, constituted substantial restrictions or conditions on the employee's right of withdrawal. However, the \$500 amount approved for withdrawal by the committee was actually the maximum amount permitted as a withdrawal in this case and, therefore, was made available to the employee. Accordingly, the employee was required to include \$500 in gross income for the year the committee's approval was granted for the withdrawal of such amount rather than the \$400 actually withdrawn.

In Revenue Ruling 77-34,²¹ a profit-sharing plan provided that an employee could withdraw his or her entire interest in the funds contributed to the plan at any time. However, if such a withdrawal was made, the employee incurred a 12-month suspension from participating under the plan, at the expiration of which, the employee could reenter the plan. During the period of suspension, no contributions could be made by the company on behalf of the employee. An employee who had been a participant in the plan for 20 years died while still employed, having made no request for a withdrawal. The entire amount credited to the decedent's account was payable to the designated beneficiary in several payments over a period of years. The question was whether the decedent's beneficiary received the decedent's share of the plan under the terms of the plan, or from the decedent who constructively received the payments prior to death. The IRS stated that if participants were permitted to withdraw employer contributions subject to the suspension of participation for a specified period during which no contributions were made by the employer on behalf of such employees, such suspension represented a substantial restriction or limitation and the amounts that were permitted to be withdrawn were not made available to the employee. Therefore, the decedent's interest in the employee trust was not constructively received prior to death.²²

The payment of a financial percentage, or what is commonly referred to as a *haircut* is related to the concept of plan suspension established to limit withdrawals and has been considered to be a limitation or restriction on the availability of compensation. In Revenue Ruling 55-423,²³ which involved a plan suspension, the IRS noted that

[i]n the penalty type of case a participant, who makes a withdrawal, is required to discontinue his participation in the trust or suffer a forfeiture with respect to a portion of his distributable interest. Discontinuance of participation is the surrender of a valuable right and, as long as that remains a condition for withdrawal of his interest, such interest is not made available to the participant.

²¹ Rev. Rul. 77-34, 1977-1 C.B. 276.

²² Rev. Rul. 77-34, 1977-1 C.B. 276, was made obsolete by Rev. Rul. 88-85, 1988-2 C.B. 333, to the extent it referred to IRC Sections 2039(c), (d), (e), (f), or (g).

²³ Rev. Rul. 55-423, 1955-1 C.B. 41.

Although the IRS indicated its approval of the haircut concept, the IRS did not specifically state the amount of a haircut that would be necessary to preclude constructive receipt. In determining the amount that may be considered to be a substantial limitation or restriction on the availability of deferred compensation, 10 percent is regarded as a substantial penalty amount, primarily based upon the early withdrawal penalty applicable to distributions from qualified plans, individual retirement accounts or annuities (IRAs), and IRC Section 403(b) annuities prior to attaining age 59½ as described in IRC Section 72(t). Under IRC Section 72(t), such withdrawals are generally subject to a 10 percent excise tax unless they are rolled over or they meet specific standards for an exception described in that section. Support for the use of the 10 percent amount as a sufficient penalty for premature withdrawals is based in part on the legislative history of IRC Section 72(t), which indicates that Congress believed 10 percent would be a “substantial deterrent to prevent an owner-employee from treating his retirement plan as a tax-free savings account [from] which he can withdraw prior to retirement.”²⁴ The IRS has also used the term *substantial deterrent* in General Counsel Memoranda to be synonymous with “substantial limitations or restrictions” when describing means to avoid the application of constructive receipt.²⁵

In Revenue Ruling 77-139,²⁶ the participant, at the time of death, was the president and sole shareholder of a corporation and participated in the corporation's noncontributory pension plan and, pursuant to the provisions of the plan, the decedent's spouse was designated beneficiary of a life annuity. The question was whether the decedent's sole ownership of the corporation gave the decedent the unrestricted right to receive the decedent's interest in a qualified pension plan necessary for application of the constructive receipt doctrine, or whether the decedent's beneficiary received such interest under the terms of the plan. The IRS stated that if a qualified plan of a corporation with one shareholder was terminated before the retirement or death of the participant shareholder, the corporation was required to establish that abandonment of the plan was attributable to reasons which justified not having the plan's qualification revoked retroactively. The IRS determined that the power of the decedent to terminate the plan was sufficiently restricted to prevent invocation of the doctrine of constructive receipt.²⁷

In Revenue Ruling 80-158,²⁸ the decedent was a participant in the employer's noncontributory profit-sharing plan that provided for the purchase of ordinary paid-up life insurance policies on the lives of all participating employees. On the decedent's retirement date, two policies that had been purchased by the trustee of the plan on the decedent's life were surrendered for two supplemental policies. Under the terms of the supplemental contracts, the decedent as primary payee was to receive monthly annuity payments for life with 10 years of payments guaranteed in any event. In addition, although the supplemental policies were not distributed to the decedent, the decedent had the right to designate a contingent beneficiary as the payee of any proceeds payable at death and had the right to surrender the supplemental contracts and receive the commuted value of the guaranteed payments. Upon the decedent's death, the remaining guaranteed installments under the supplemental contracts were paid to the designated contingent beneficiary. In this case, the decedent had the right during the 10-year period of guaranteed payments to surrender the rights under the profit-sharing plan for the commuted value of the remaining guaranteed payments. If the decedent had exercised the right to receive the commuted value of the guaranteed payments, the decedent would have suffered a significant economic penalty, because the amount required to purchase a new annuity of comparable value would have been greater than the commuted value of the remainder of the 10-year certain payments. Thus, the decedent's control over the guaranteed payments was subject to a substantial limitation

²⁴ H.R. Rep. No. 779, 93d Cong., 2d Sess. p. 116, 1974-3 C.B. 359.

²⁵ See, e.g., GCM 37562.

²⁶ Rev. Rul. 77-139, 1977-1 C.B. 278.

²⁷ Rev. Rul. 77-139, 1977-1 C.B. 278, 1977 WL 44402 was made obsolete by Rev. Rul. 88-85, 1988-2 C.B. 333, 1988 WL 546812, to the extent it referred to Sections 2039(c), (d), (e), (f), or (g).

²⁸ Rev. Rul. 80-158, 1980-1 C.B. 196.

or restriction, and the decedent's interest in the profit-sharing trust was not constructively received by the decedent prior to death.²⁹

In Revenue Ruling 80-300,³⁰ a corporation adopted a plan under which key employees of the corporation were granted stock appreciation rights. The stock appreciation rights entitled the employee to a cash payment equal to the excess of the fair market value (FMV) of one share of the common stock of the corporation on the date of the exercise of the stock appreciation right over the FMV of a share on the date the stock appreciation right was granted to the employee. The IRS stated that the forfeiture of a valuable right is a substantial limitation that precludes constructive receipt of income. The employee's right to benefit from further appreciation of stock, in this case, without risking any capital was a valuable right. However, once the employee exercised the stock appreciation rights, the employee lost all chance of further appreciation with respect to that stock and the amount payable became fixed and available without limitation. Accordingly, the employee would be in receipt of income on the day the stock appreciation rights were exercised.

Generally, as long as the deferred compensation arrangement is unfunded or contains a substantial restriction, such as a period of nonparticipation or an economic penalty, and the participants in the arrangement have no current right to receive a payment under the arrangement, the doctrine of constructive receipt will not apply. Also, pursuant to several court opinions which have addressed this doctrine, if an agreement to defer compensation is entered into prior to the period of service for which the compensation is payable or to the date on which the amount payable is ascertainable, the doctrine is not likely to be applied.

Economic Benefit Doctrine

Contributions made pursuant to a nonqualified deferred compensation plan are generally not includable in the employee's income under the economic benefit doctrine, which identifies when income has actually been received other than by a direct payment of cash. If contributions are made or amounts set aside in accordance with a nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, then such contributions or amounts should not be subject to the economic benefit doctrine. However, if contributions to the plan are protected from the employer's creditors and the rights of the plan participants to the benefits provided under the plan are nonforfeitable, the economic benefit doctrine should apply, and the contributions would be includable in the participant's income.

Under the economic benefit doctrine, if any economic or financial benefit is conferred on an individual as compensation in a taxable year, it is taxable to the individual in that year. In *Commissioner v. Smith*,³¹ an employer gave an employee, as compensation for his services, an option to purchase from the employer certain shares of stock of another corporation at a price not less than the then value of the stock. In two later years, when the market value of the stock was greater than the option price, the employee exercised the option, purchasing large amounts of the stock in each year. The Tax Court had determined that the excess of the market value of the shares over the option price in the years in which the shares were received by the employee was compensation for his services and taxable as income in those years. The United States Supreme Court agreed and concluded that the employee received an economic benefit at the time he received the shares and, as a result, the employee had taxable income in each year in which stock was acquired.

²⁹ Rev. Rul. 80-158, 1980-1 C.B. 196, was made obsolete by Rev. Rul. 88-85, 1988-2 C.B. 333, to the extent it referred to IRC Sections 2039(c), (d), (e), (f), or (g).

³⁰ Rev. Rul. 80-300, 1980-2 C.B. 165.

³¹ *Commissioner v. Smith*, 324 U.S. 177, 65 S.Ct. 591, 89 L.Ed. 830 (1945), reh. den. 324 U.S. 695, 65 S.Ct. 891, 89 L.Ed. 1295 (1945).

Assignment of Income Doctrine

The doctrine of assignment of income is similar to the economic benefit doctrine because, as the United States Supreme Court pointed out in *Helvering v. Horst*,³² the power to dispose of income represents the equivalent of ownership and the exercise of a power to dispose of income represents the equivalent of taxable enjoyment. If a future benefit may be currently assigned to another party, the person assigning the benefit may be subject to current taxation under this doctrine.³³

The doctrine was formalized by the United States Supreme Court in *Lucas v. Earl*.³⁴ The question in that case was whether Earl could be taxed for the whole of the salary and attorneys' fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife. The contract, made in 1901, provided that the salary and fees earned by Earl became the joint property of Earl and his wife on the very first instant on which they were received. The Court held that "the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." The Court further stated that it believed that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."

In *Commissioner v. P.G. Lake, Inc.*,³⁵ the taxpayers assigned the right to a specified sum of money, payable out of a specified percentage of oil, or the proceeds received from the sale of such oil, if, as, and when produced in return for cash. The Court concluded that, while the oil payments were interests in land, the consideration received for the oil payment rights was taxable as ordinary income because the lump-sum consideration was essentially a substitute for what would otherwise be received at a future time as ordinary income.

Thus, the assignment of income doctrine is likely to be applied if a taxpayer assigns his or her right to receive a benefit to a third party as consideration for some other benefit. However, the assignment of income doctrine is not likely to be applied in the case if a benefit promised under the terms of a deferred compensation plan may not be alienated, sold, transferred, or assigned.³⁶

Cash Equivalency Doctrine

The cash equivalency doctrine is similar to the economic benefit doctrine and the assignment of income doctrine, and provides that if a promise to pay some benefit to an individual is unconditional and can be exchanged for cash, then the promise is equivalent to cash and subject to current taxation.

If a promised benefit may not be transferred or assigned to another party and is subject to certain conditions, this doctrine should not apply.

Transfer of Property

The creation of a nonqualified deferred compensation plan generally will not result in a transfer of property to an employee triggering tax under IRC Section 83. If contributions or amounts set aside in accordance with a

³² *Helvering v. Horst*, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 (1940).

³³ *United States v. Basye*, 410 U.S. 441, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973), rehearing denied 411 U.S. 940, 93 S.Ct. 1888, 36 L.Ed.2d 402 (1973).

³⁴ *Lucas v. Earl*, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930).

³⁵ *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958), rehearing denied 356 U.S. 964, 78 S.Ct. 991, 2 L.Ed.2d 1071 (1958).

³⁶ Private Ltr. Rul. 9340032, dated July 6, 1993, regarding the division of nonqualified deferred compensation in a divorce, and Private Ltr. Rul. 9405021, dated November 8, 1993, for recent discussions of the assignment of income doctrine.

nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, such contributions or amounts should not be considered to be a transfer of property under IRC Section 83. In general, IRC Section 83 provides rules for the taxation of property transferred to any person in connection with the performance of services. This property is generally not taxable to the person until it has been transferred to such person or becomes substantially vested in such person. Section 1.83-3(a)(1) of the Treasury Regulations provides that a transfer of property occurs when a person acquires a beneficial ownership interest in the property.³⁷

Section 1.83-3(b) of the Treasury Regulations provides that property is substantially vested for purposes of IRC Section 83 when it is either transferable or not subject to a substantial risk of forfeiture. Section 1.83-3(c) of the Treasury Regulations provides that whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists if rights in property that are transferred are conditioned upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Section 1.83-3(d) of the Treasury Regulations provides that the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture.

Section 1.83-3(e) of the Treasury Regulations provides that for purposes of IRC Section 83, the term *property* includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor.

If employer contributions made pursuant to a nonqualified deferred compensation plan are subject to the claims of the employer's general creditors, then such contributions are not considered property under IRC Section 83. Therefore, at the time the contributions are made, there is no transfer of property under IRC Section 83. However, if the contributions are not available to the employer and are protected from the employer's general creditors in the event of the employer's bankruptcy, and the participating employee is fully vested in the contributions, then a transfer of property would be considered to have occurred under IRC Section 83 and the employee would be subject to tax on the transferred amount.

Dominion and Control

A question frequently raised is whether a right of a participant in a nonqualified deferred compensation plan to select among various investment options offered under the terms of the plan should trigger current income. Control over the investment of deferred amounts raises the issue of whether the participant is entitled to the deferred compensation if the participant exercises control over the deferred compensation. Simply stated, the issue is whether some degree of dominion or control over the deferred compensation should lead to earlier taxation.

The regulations under IRC Section 457, however, provide a basis for arguing that the ability to direct investments should not result in current taxation to the participant. The IRS has puzzled over participant involvement in the investment process and has issued a number of opinions and rulings that considered participant involvement in the investment process. In early opinions and rulings, the IRS determined that involvement in the investment process by a participant could cause the benefits to be currently taxable. However, subsequent opinions and rulings have indicated that such involvement is acceptable so long as the trustee of a trust or the employer sponsoring the plan is not obligated to obtain the assets requested as an investment.

³⁷ See TAM 9438001, dated April 21, 1994, for a discussion regarding the application of IRC Section 83 on a stock option arrangement.

In the early years, the IRS concluded that amounts withheld from an employee's gross income under a nonqualified deferred compensation plan were currently includable in the employee's gross income if the employee had a right to receive income but voluntarily directed the employer to withhold it and the employee could direct the employer to invest the sums for the employee's benefit. In General Counsel Memorandum (GCM) 36998 (February 9, 1977), the IRS reviewed two proposed revenue rulings regarding the investment of assets under deferred compensation agreements. In the GCM, the IRS stated that it believed that the amounts withheld from the compensation of participating employees in the plans subject to the proposed revenue rulings were includable in the gross income of the employees in the year withheld because the employees had exercised sufficient "dominion and control" over the withheld amounts to warrant the imposition of income tax upon them.

The dominion and control theory has not, however, been advanced in subsequent opinions and rulings regarding the investment of assets in connection with a nonqualified deferred compensation plan. The subsequent opinions and rulings have relied on the analysis of the constructive receipt doctrine and the economic benefit doctrine.

The rulings issued by the IRS subsequent to the publication of GCM 36998 in 1977, pertaining to the investment of assets to be used, directly or indirectly, for the payment of deferred compensation or retirement benefits of highly compensated employees (HCEs) have varied. In a number of cases, the employer set aside funds and the employee was permitted, by the plan or trust, to suggest the manner of investing the assets, but the employer or trustee was not required to follow the advice. In other rulings, funds were invested by a fiduciary in the type of assets requested or selected by the participant (usually from a specified group of assets). In each of the rulings, the IRS concluded that the ability under the applicable trust of the participant to recommend investments in a certain asset, or to benefit from the indexed earnings of a particular investment even though that investment was not required to be made with specified assets, did not generally result in the funds in the trust or allocated under the plan being treated as currently taxable to the employee.

The purpose of deferred compensation generally is to provide benefits to a select group of HCEs to permit the employees' employer to attract such employees and to provide "a means to retain valuable employees."³⁸ Furthermore, "Congress recognized that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA]."³⁹ To cast a wider net and include a significant number of employees in a nonqualified deferred compensation plan could impose a significant tax burden on the employer, which would require the current recognition of the liability but a deferral of the deduction for the deferred amounts.

Deferred Compensation

Nonqualified deferred compensation arrangements are an important method for compensating executives and HCEs of both publicly held and private companies, as well as key personnel of tax-exempt organizations. Because of the flexibility of these plans, for taxable employers at least, and the wide variety of plan designs, the reasons for these arrangements are as varied as the plans themselves. Although many of the purposes of the plans may be driven by nontax considerations, the tax and accounting consequences are always important elements.

³⁸ *Demery v. Extebank Deferred Compensation Plan (B)*, 216 F.3d 283 (2d Cir. 2000).

³⁹ Department of Labor Advisory Opinion 90-14A, dated May 8, 1990.

The objective of an employee in participating in these plans is typically to ensure that he or she will be taxed only when payments are actually received under the agreement; to permit deferred amounts to grow on a pretax and tax-deferred basis during the deferral period; and to have amounts paid concurrently with some specific purpose, such as retirement. The motive of the employer providing these arrangements is most often the need to attract and retain the people who are essential to the growth and future of the company. After all, most of the competitors of the employer provide similar benefits to their executives or prospective executives. Having agreed to provide deferred compensation, an employer also wants to ensure that it receives a deduction for the deferred amounts when the compensation is paid or payable to the employee.

Retirement income is probably the primary reason for nonqualified deferred compensation arrangements. Before the Employee Retirement Income Security Act of 1974, as amended (ERISA), there were no dollar limits on contributions and benefits under qualified plans, and executives generally accrued retirement benefits under those plans just like other salaried employees. With ERISA, however, monetary limitations on qualified plans first appeared. Since then, tax legislation has added further complexity, restrictions, and limitations to qualified plans. Although in the past, the qualified plan may have provided the bulk of the retirement income of an executive and a nonqualified plan played only a secondary role, the roles have now been reversed with the limitations on contributions and benefits under qualified plans. In many instances, the nonqualified deferred compensation plan has become the principle source of executive retirement benefits.

A nonqualified deferred compensation plan is narrow in focus and coverage, and not without risk to a participant and must be structured to comply with Section 409A or structured so that it is not subject to Section 409A. The typical form of a nonqualified deferred compensation plan is a plan structured to comply with Section 409A and as a plan that is commonly referred to as a top-hat plan.

Deferred Compensation Under Section 409A

For purposes of the effective date of Section 409A, Section 1.409A-6(a)(3) of the Final Treasury Regulations provides that, with respect to nonaccount balance plans, the amount of compensation deferred before January 1, 2005, equals the present value as of December 31, 2004, of the amount to which the service provider would be entitled under the plan if the service provider voluntarily terminated services without cause on December 31, 2004, and received a payment of benefits available from the plan on the earliest possible date allowed under the plan to receive a payment of benefits following the termination of services and receives the benefits in the form with the maximum value. For purposes of determining the present value of the benefit, the actuarial assumptions contained in the plan are used provided the assumptions are reasonable; otherwise, reasonable actuarial assumptions are required to be used.

For purposes of the effective date of Section 409A, Section 1.409A-6(a)(3) of the Final Treasury Regulations provides that, with respect to account balance plans, the amount of compensation deferred before January 1, 2005, equals the portion of the account balance of the service provider as of December 31, 2004, the right to which is earned and vested as of December 31, 2004, plus any future contributions to the account, the right to which was earned and vested as of December 31, 2004.

In general, IRC Section 409A and Section 1.409A-1(c) of the Final Treasury Regulations define the term “plan” to mean any agreement, method, program or other arrangement, including an agreement, method, program or arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated or agreed to by the service recipient and one or more service providers or service provider representatives.

Section 1.409A-1(a) of the Final Treasury Regulations provides that the term “nonqualified deferred compensation plan” does not include qualified retirement plans described in IRC Section 401(a), tax-deferred annuities, simplified employee pension plans, SIMPLE plans, eligible deferred compensation plans described in IRC Section 457(b), any plan described in IRC Section 415(m), and certain welfare benefit plans including bona fide vacation, sick leave, compensatory time, disability pay and death benefit plans, are specifically exempt from Section 409A.

Section 1.409A-1(b) of the Final Treasury Regulations provides that, in general, a nonqualified deferred compensation plan provides for the “deferral of compensation” if a service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later taxable year. A service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. Certain customary payroll practices generally are not considered a deferral of compensation. For example, compensation paid after the end of an employee's taxable year, pursuant to the timing arrangement under which the service recipient normally compensates services providers for services performed during a payroll period, does not constitute a deferral of compensation. Also, under Section 1.409A-1(b)(4) of the Final Treasury Regulations, a deferral of compensation does not occur if compensation is actually or constructively received by a service provider by the later of the 15th day of the third month after the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or the 15th day of the third month after the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

Initial Deferral Elections

Generally, pursuant to Section 409A(a)(4)(B)(i) and (ii), and Section 409A-2(a) of the Final Treasury Regulations (72 Fed. Reg. 19234, 19301, April 17, 2007), a plan that is, or constitutes part of, a nonqualified deferred compensation plan meets the requirements of Section 409A(a)(4)(B) only if under the terms of the plan, compensation for services performed during a service provider's taxable year (the service year) may be deferred at the service provider's election only if the election to defer such compensation is made and becomes irrevocable not later than the latest date permitted under Section 1.409A-2(a) of the Final Treasury Regulations. An election will not be considered to be revocable merely because the service provider or service recipient may make an election to change the time and form of payment pursuant to the requirements of Section 1.409A-2(b), regarding subsequent changes in time and form of payment, or the service recipient may accelerate the time of payment pursuant to the requirements of Section 1.409A-3(j)(4), regarding exceptions to the prohibition on accelerated payments. For purposes of this Section 1.409A-2, an election to defer includes an election as to the time of the payment, an election as to the form of the payment or an election as to both the time and the form of the payment, but does not include an election as to the medium of payment (for example, an election between a payment of cash or a payment of property). Except as otherwise provided in the regulations, an election will not be considered made until such election becomes irrevocable under the terms of the applicable plan.

Section 1.409A-2(a)(3) of the Final Treasury Regulations provides that a plan that is, or constitutes part of, a nonqualified deferred compensation plan meets the requirements of Section 409A(a)(4)(B) if under the terms of the plan, compensation for services performed during a service provider's taxable year (the service year) may be deferred at the service provider's election only if the election to defer such compensation is made not later than the close of the service provider's taxable year next preceding the service year.

Section 1.409A-2(A)(4) of the Final Treasury Regulations provides that if a service provider has a legally binding right to a payment of compensation in a subsequent taxable year that, absent a deferral election,

would be treated as a short-term deferral within the meaning of Section 1.409A-1(b)(4), an election to defer the compensation may be made in accordance with the requirements of Section 1.409A-1(b) applied as if the amount were a deferral of compensation and the scheduled payment date for the amount were the date the substantial risk of forfeiture lapses.

Section 1.409A-2(a)(7) of the Final Treasury Regulations provides that in the case of the first year in which a service provider becomes eligible to participate in a plan, the service provider may make an initial deferral election within 30 days after the date the service provider becomes eligible to participate in the plan, with respect to compensation paid for services to be performed after the election.

An important exception to the general rule is provided for “performance-based compensation.” IRC Section 409A(a)(4)(B)(iii) and Section 1.409A-2(a)(8) of the Final Treasury Regulations provide that in the case of any performance-based compensation based on the satisfaction of preestablished performance criteria relating to services performed over a period of at least 12 months (provided that the service provider performed services continuously from the later half of the beginning of the performance period or the date upon which the performance criteria are established through a date no earlier than the date upon which the service provider makes an initial deferral election) an initial deferred election may be made with respect to such performance-based compensation no later than six months before the end of the performance period (provided that in no event may an election to defer performance-based compensation be made after such compensation has become both substantially certain to be paid and readily ascertainable). Section 1.409A-1(e) of the Final Treasury Regulations provides that performance criteria are considered to be preestablished if established in writing no later than 90 days after the commencement of the service period.

Subsequent Deferral Elections

IRC Section 409A(a)(4)(C) and Section 1.409A-2(b) of the Final Treasury Regulations provide rules for “a subsequent election” (that is, elections after compensation has been deferred on behalf of a participant that change either the time or form of distribution). Three requirements must be met in order for a plan to permit participants to change either the time or form of distribution after an initial deferral election. First, the plan must require that the subsequent deferral election not take effect until at least 12 months after the date on which the election is made. Second, if the subsequent deferral election relates to a distribution to be made on separation from service, a specified time or a change of control, then the first payment with respect to which such election is made must be deferred for a period of not less than five years from the date the payment would otherwise have been made. Third, if the subsequent deferral election relates to a distribution that otherwise was to be paid at a specified time, then the election must be made at least 12 months before the date of the first scheduled payment.

Distribution Requirements

IRC Section 409A(a)(2) and Section 1.409A-3(a) of the Final Treasury Regulations require that compensation deferred under a plan may be paid only on account of one or more of the following: (i) separation from service as defined in Section 1.409A-1(h), (ii) the date a participant becomes disabled as defined in the statute and Section 1.409A-3(i)(4) of the Final Treasury Regulations, (iii) a specified time or pursuant to a fixed schedule specified in the plan and Section 1.409A-3(i)(1) of the Final Treasury Regulations, (iv) the death of the service provider, (v) a change in control as defined in Section 1.409A-3(i)(5) of the Final Treasury Regulations, and (vi) the occurrence of an unforeseeable emergency as defined in the statute and Section 1.409A-3(i)(3) of the Final Treasury Regulations. In addition, a nonqualified deferred compensation plan must also prohibit distributions to a “specified employee” on account of separation from service before the date that is six months after the separation from service (or, if earlier, the date of death of the specified employee). For this purpose, a “specified employee” is generally defined to mean a “key employee” (as that term is defined under IRC

Section 416(i) of a publicly traded corporation. IRC Section 416(i) provides that a key employee generally includes up to 50 officers of the employer having annual compensation greater than \$130,000 (indexed, \$145,000 for 2007), 5 percent owners, and 1 percent owners having annual compensation from the employer greater than \$150,000.

The term “separation from service” was used instead of the term “severance from employment,” which is generally more limited and avoids the application of the “same desk” rule (continuing in the same job for a different employer as a result of liquidation, merger, or consolidation of the employee’s former employer does not constitute separation from service) associated with the phrase “separation from service.” The IRS appears to have used the phrase “separation from service” to avoid artificial terminations of employment as triggering events for distributions. This suggests the re-emergence of the “same desk” rule at least to a certain extent, under Section 409A.

Section 409A(a)(2)(C) and Section 1.409A-3(i)(4) of the Final Treasury Regulations provide that a participant will be considered “disabled” if the participant: (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant’s employer; or (iii) determined to be disabled by the Social Security Administration.

With respect to distributions that can be made at a “specified time,” the Conference Committee Report and Section 1.409A-3(i)(1) of the Final Treasury Regulations state that only a specified time, and not an event, can qualify as a specified time under Section 409A. For example, distribution of an amount to a participant when the participant attains age 65 is payable at a specified time, while an amount payable when a participant’s child begins college would not qualify as a distribution at a “specified time.” Instead, a participant would need to designate the time for the distribution when making the deferral election in order to satisfy this rule.

IRS Section 409A(a)(2)(B)(ii) and Section 1.409A-3(i)(3) of the Final Treasury Regulations define the term “unforeseeable emergency” as a severe financial hardship to the service provider resulting from an illness or accident of the service provider or the service provider’s beneficiary, spouse, or a dependent (as defined in IRC Section 152(a)), loss of the service provider’s property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider. This requirement is met only if the amounts distributed with respect to an emergency do not exceed the amounts reasonably necessary to satisfy such emergency, plus amounts reasonably necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such hardship is or may be relieved through cancellation of a deferral election upon payment due to an unforeseeable emergency.

IRS Compliance Resolution Program for Section 409A

In Announcement 2007-18,⁴⁰ issued on February 8, 2007, the IRS announced a compliance resolution program that permitted employers to pay the additional taxes arising under IRC Section 409A due to the exercise of certain discounted stock options and stock appreciation rights in 2006. The program provided a means to minimize the burdens of compliance on employees who were not corporate insiders, while ensuring that all applicable taxes were paid. The program: (i) applied only to discounted stock rights exercised during 2006, (ii) applied only to employees and former employees who were not subject to the disclosure requirements under Section 16(a) of the Securities Exchange Act of 1934 (a non-insider), and were not subject

⁴⁰ Announcement 2007-18, 2007-9 IRB, 02/08/2007.

to such requirements at the date of grant of the stock right, (iii) required full payment by the employer of the applicable Section 409A taxes arising from the exercise of the stock right, (iv) provided relief for the employees from the requirement to pay the Section 409A taxes, (v) did not affect an employer's obligation to report the compensation income and wages arising from the exercise of the stock right on the Form W-2, in Box 1, 3 and 5 and to apply the appropriate employment taxes, and did not affect an employee's obligation to report such compensation income on the Form 1040 and pay the applicable income tax (other than the additional Section 409A taxes), (vi) required treatment of the employer's payment of the employee's Section 409A taxes as an additional payment of compensation to the employee in the employee's taxable year in which the payment is made, and (vii) required notice to employees and to the IRS of the employer's participation in the program.

Employers that desired to participate in the program were required to notify the IRS no later than February 28, 2007, of their intent to participate. Although this program is not presently available, it does provide interesting relief for failures with respect to the requirements of Section 409A.

Top-Hat Plan

The term *top-hat* refers to a plan described in IRC Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA, as an employee benefit plan which is unfunded and maintained by an employer "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." A top-hat plan is exempt from the substantive provisions of ERISA, Parts 2, 3, and 4 of Title I of ERISA, pertaining to participation, vesting, funding, and fiduciary responsibilities pursuant to the exemptions in Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA.⁴¹ A top-hat plan is a common form of a deferred compensation arrangement that is designed to avoid the application of both the constructive receipt doctrine and the economic benefit doctrine.

Whether a plan falls within this description is not easily determined but there is some guidance regarding the interpretation of the terms used in this phrase that is helpful in making such a determination.

Primarily

The Department of Labor (DOL) stated in a footnote in DOL Advisory Opinion 90-14A, dated May 8, 1990, that it is the position of the department that

[T]he term "primarily," as used in the phrase "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" in sections 201(2), 301(a)(3) and 401(a)(1), refers to the purpose of the plan (i.e., providing benefits) and not the participant composition of the plan. Therefore, a plan which extends coverage beyond "a select group of management or highly compensated employees" would not constitute a "top hat" plan for purposes of Parts 2, 3 and 4 of Title I of ERISA.

In other words, according to the DOL, *primarily* applies only to "the purpose of providing deferred compensation" and does *not* apply to "a select group of management or highly compensated employees." This effectively means that the plan can cover *only* "a select group of management or highly compensated employees."

⁴¹ *Carr v. First Nationwide Bank*, 816 F.Supp. 1476 (N.D.Cal.1993).

Select Group

The term *select group* has been the subject of interpretation by several courts. The court in *Belka v. Rowe Furniture Corporation*,⁴² found that a plan covering only 4.6 percent of the employer's total number of employees was within the meaning of a select group. In *Darden v. Nationwide Mutual Insurance Company*,⁴³ the district court found that a group comprising almost one-fifth of the employer's total work force was too large to be considered select for purposes of the top-hat exemption. (On appeal, Nationwide did not contest this conclusion.) In *Starr v. JCI Data Processing, Inc.*,⁴⁴ the court found that where participation in a plan was predicated on whether an employee had previously worked for the employer's former parent company, resulting in participation representing many levels from nonsupervisory clerical positions (38 percent), line supervisors (25 percent), and upper management (38 percent), whose salaries ranged from \$12,000 to \$336,000, the plan was not for the benefit of a select group of management or highly compensated employees. In *Carrabba v. Randalls Food Markets, Inc.*,⁴⁵ the district court stated that “[t]he definition of a top hat plan has been described as a narrow one. See *In re New Valley Corp.*, 89 F. 3d 143, 148 (3d Cir. 1996), *cert. denied*, 519 U.S. 1110, 117 S. Ct. 947, 136 L. Ed. 2d 835 (1997).” The District Court articulated its view regarding the definition of a top-hat plan:

[a] legitimate top hat plan must cover a “select group” of employees who are “only high-level employees.” [Citing *In re New Valley Corp.*] The mere fact that the employer intends the plan to be a reward to “key” employees does not satisfy the degree of selectivity contemplated by the statutes. See *Hollingshead v. Burford Equip. Co.*, 747 F. Supp. 1421, 1429 (M. D. Ala. 1990). Rather, the statute contemplates that a top hat plan will be for the benefit of “high-ranking employees.”⁴⁶

Management

The term *management* has been the subject of interpretation in the legislative history of ERISA. As an example of an unfunded plan primarily devoted to providing deferred compensation for a select group of management or HCEs, the legislative history of ERISA cites a “phantom stock” or “shadow stock” plan established solely for the officers of a corporation. For an employer with many officers, this would suggest a broad interpretation of who may be considered eligible to participate in a top-hat plan. However, the DOL has ruled that a plan which covered all of the employees on an employer's executive payroll was not a plan maintained for a select group of management or HCEs in view of the broad range of salaries and positions held by the employees. Apparently, the DOL has taken a narrow approach with respect to the definition of this term for purposes of the top-hat plan exemption.⁴⁷

Highly Compensated

The DOL has also taken a narrow approach with respect to the interpretation of the term *highly compensated*. Specifically, the department's position is that the term is narrower than the definition of *highly compensated employee* under the IRC. In the preamble to Section 1.414(q)-1T of the Treasury Regulations, which provides rules for determining which employees are HCEs for purposes of IRC Section 414(q),

⁴² *Belka v. Rowe Furniture Corporation*, 571 F. Supp. 1249 (D. Md. 1983).

⁴³ *Darden v. Nationwide Mutual Insurance Company*, 717 F. Supp. 388, 396-97 (E.D.N.C. 1989), *aff'd*, 922 F. 2d 203, 208 n.3 (4th Cir. 1991), *rev'd* 503 U.S. 318, 112 S. Ct. 1344, 117 L. Ed. 2d 581 (1992), on remand 969 F. 2d 76 (4th Cir. 1992).

⁴⁴ *Starr v. JCI Data Processing, Inc.*, 757 F. Supp. 390, 393-94 (D. N. J. 1991), opinion vacated in part on reconsideration 767 F. Supp. 633 (D. N. J. 1991).

⁴⁵ *Carrabba v. Randalls Food Markets, Inc.*, 38 F. Supp. 2d 468, 477 (N.D. Tex. 1999).

⁴⁶ *Carrabba* at 477.

⁴⁷ H. R. Conf. Rep. No. 93-1280, 93rd Cong., 2d. Sess. 296 (1974), *reprinted in* 1974 U.S. Code Cong. & Ad. News 5038, 5076-77; Department of Labor Advisory Opinion 85-37A, October 25, 1985.

published on February 19, 1988,⁴⁸ the Department of Treasury stated that the DOL has jurisdiction over the interpretation of Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA. However, the Department of Treasury further stated that it “would like to clarify its understanding that section 414(q) is not determinative with respect to provisions of Title I of ERISA, other than those provisions that explicitly incorporate such section by reference (e.g., section 408(b)(1)(B) of ERISA).” Furthermore, the Department of Treasury stated in the preamble that “[t]he Departments of Treasury and Labor concur in the view that a broad extension of section 414(q) to determinations under sections 201(2), 301(a)(3), and 401(a)(1) of ERISA would be inconsistent with the tax and retirement policy objectives of encouraging employers to maintain tax-qualified plans that provide meaningful benefits to rank-and-file employees.”⁴⁹

Ambiguity in Plan Terms

Although the status of a plan as a top-hat plan may turn on the interpretation of the terms used to define a top-hat plan, the compensation payable under the plan may turn on the precise use of the terms in the plan.

Reason for ERISA Exemption for Top-Hat Plans

The participants in a top-hat plan are considered to be knowledgeable about the employer and the risks and rewards related to such a plan, not requiring the protection of ERISA; therefore, they can influence the design and benefits of a top-hat plan and assume the associated risks.

The DOL expressed its view of the reason for, and justification of, the top-hat exemption in DOL Advisory Opinion 90-14A, dated May 8, 1990:

[i]t is the view of the Department that in providing relief for “top-hat” plans from the broad remedial provisions of ERISA, Congress recognized that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I [of ERISA].

Because of this legislative purpose, the phrase “select group of management or highly compensated employees” will be interpreted narrowly by the DOL.⁵⁰

Whether a Plan Satisfies the Purpose and the Description of a Top-Hat Plan

The courts have generally taken the position that ERISA should be liberally construed in favor of employee benefit fund participants and that exemptions from the ERISA coverage should be confined to their narrow purpose.

Although the DOL has not issued any rulings specifically stating how a top-hat plan is defined for purposes of Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA, the guidance issued by the Departments of Labor and Treasury, and the courts suggests that the eligibility requirements for participation in a nonqualified deferred compensation plan that is intended to satisfy the definition of a top-hat plan should be narrowly applied so that the number of employees who are eligible to participate is limited to a select group of high-level employees whose average compensation is significantly greater than the average compensation of all other employees.

⁴⁸ 53 Fed. Reg. 4965, 4967 (February 19, 1988).

⁴⁹ 53 Fed. Reg. 4965, 4967 (February 19, 1988).

⁵⁰ See also DOL Adv. Op. 92-13A, dated May 19, 1992.

Cases Addressing the Elements of a Top-Hat Plan

In *Alexander v. Brigham and Women's Physicians Organization, Inc.*,⁵¹ the district court concluded that two deferred compensation plans for highly compensated physicians were top-hat plans not protected by the vesting and fiduciary responsibility provisions of ERISA. Judge Mark L. Wolf determined that the plans, which allowed the top-earning surgeons at Harvard Medical School to reduce their salary by a certain percentage and credit that amount to the plans, were created to defer compensation for a select group of highly compensated employees. The court noted that the fact that the plans were established with a desire to recruit and retain excellent employees did not take away their top-hat status. Therefore, the plans did not violate ERISA when they reduced by approximately \$442,000 the amount in a physician's plan to offset his practice deficit after his employment was terminated.

In *Craig v. Pillsbury Non-Qualified Pension Plan*,⁵² the Eighth Circuit Court of Appeals determined that the administrator of a top-hat plan sponsored by Pillsbury Company abused its discretion when it excluded from the calculation of the benefits of a plan participant two retention bonuses the participant received in 2001 while working for a subsidiary of Pillsbury Company. The court found that while the administrator had the discretion to exclude from the calculation of the benefits of the participant any compensation the participant received from the subsidiary, once the administrator made the decision to include this compensation in the calculation of the benefits, the administrator did not have the discretion to exclude bonuses received by the participant. According to the decision of the court, the top-hat plan unambiguously defined the term "compensation" to include bonuses.

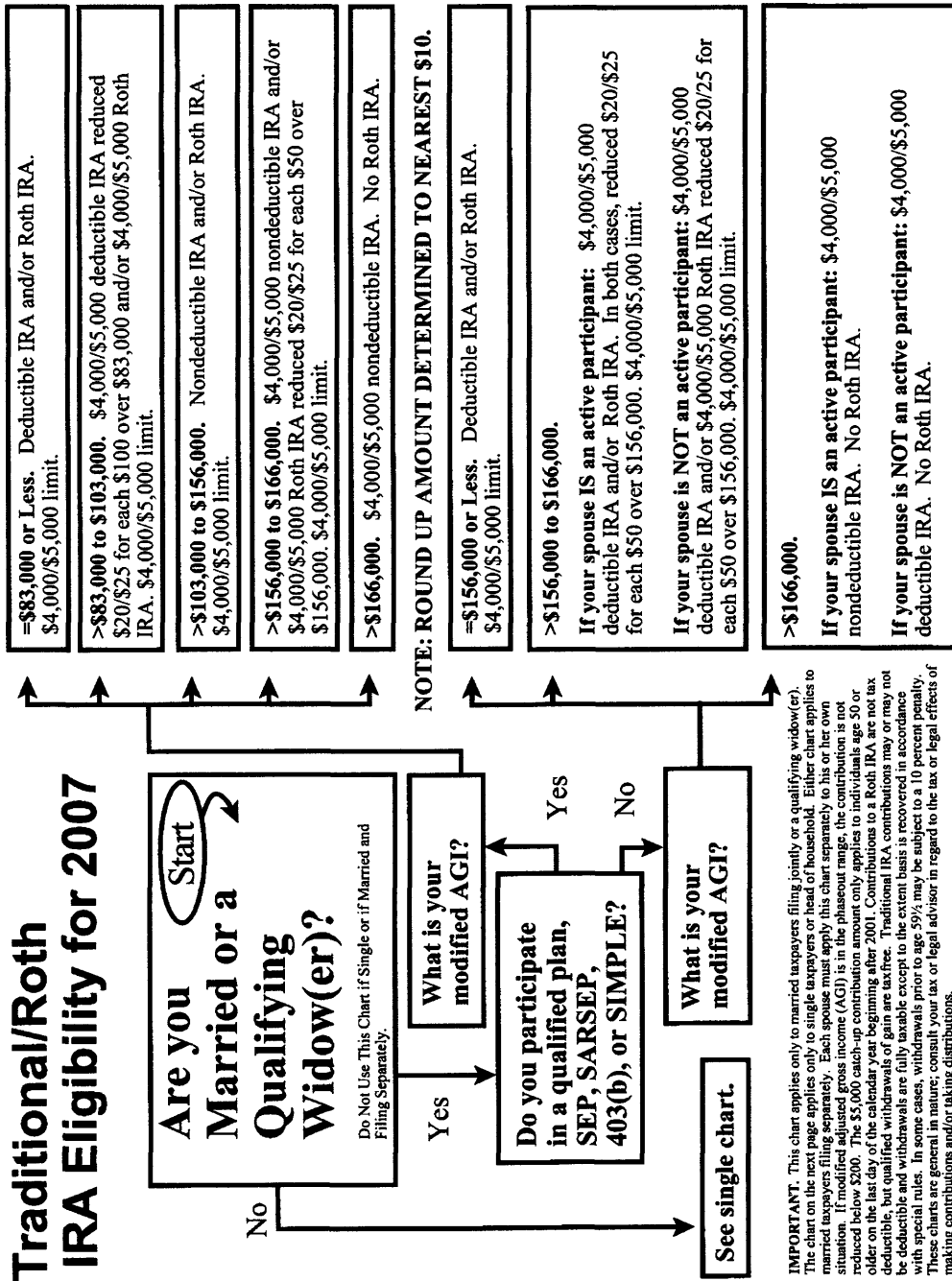
In *Crowell v. Shell Oil Co., S.D. Tex.*,⁵³ the United States District Court for the Southern District of Texas ruled that Shell Oil Company did not act arbitrarily when it calculated benefits under its top-hat plan to exclude any stock options exercised by a plan participant prior to the March 2002 merger of Shell Oil Company with Pennzoil-Quaker State Company. In dismissing the claim of two former Pennzoil workers that Shell Oil Company wrongly calculated their top-hat plan benefits by not including stock options they had exercised prior to March 2002, the court found that Shell Oil Company had consistently interpreted an amendment to its Retirement Plan in a manner that excluded pre-March 2002 stock option exercises from the calculation of a participant's "considered compensation."

⁵¹ *Alexander v. Brigham and Women's Physicians Organization, Inc.*, D. Mass., No. 04-10738-MLW, December 26, 2006.

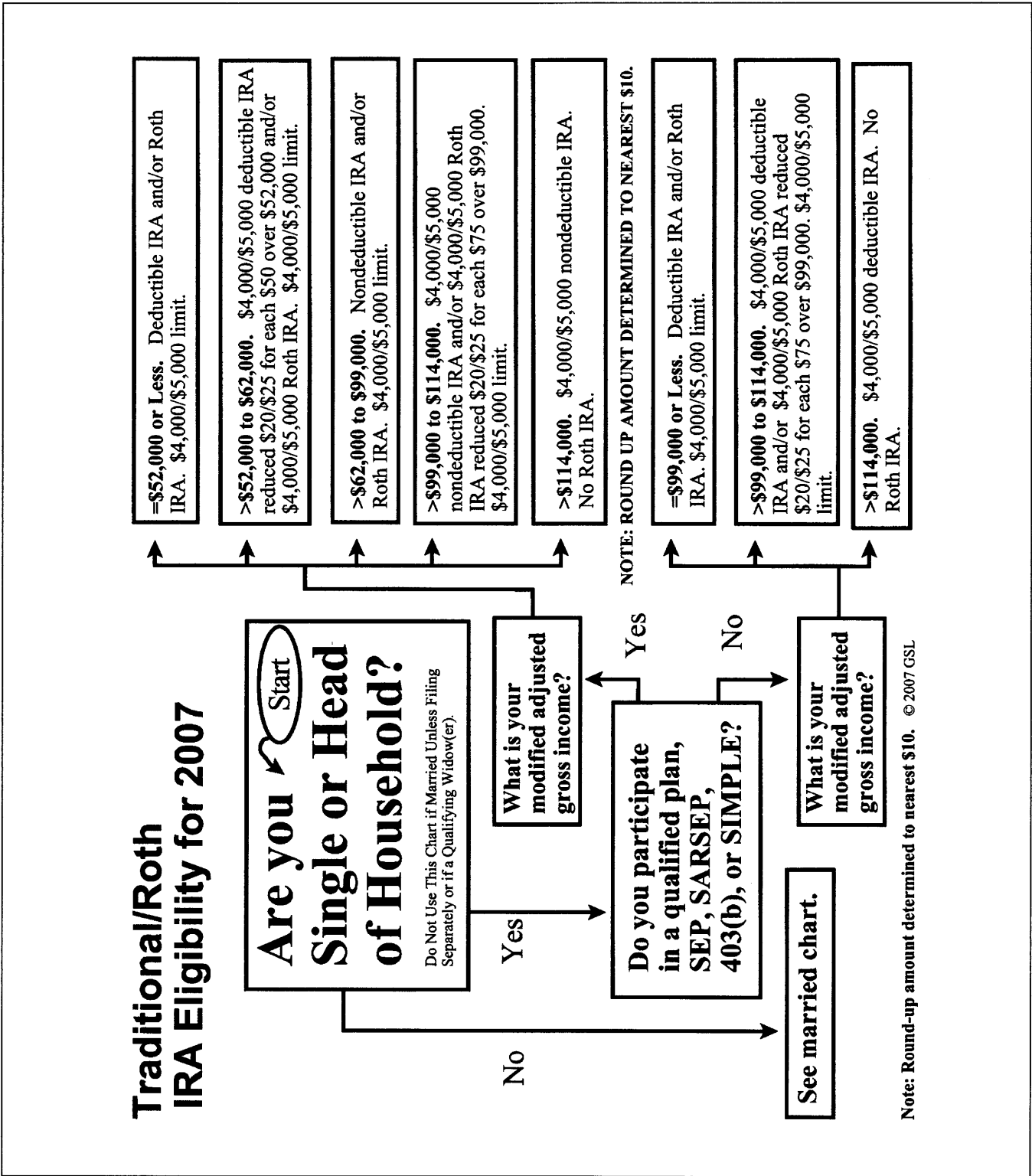
⁵² *Craig v. Pillsbury Non-Qualified Pension Plan*, No. 05-2211 (8th Cir., August 14, 2006).

⁵³ *Crowell v. Shell Oil Co., S.D. Tex.*, No. H-05-03412 (March 7, 2007).

Traditional/Roth IRA Eligibility for 2007



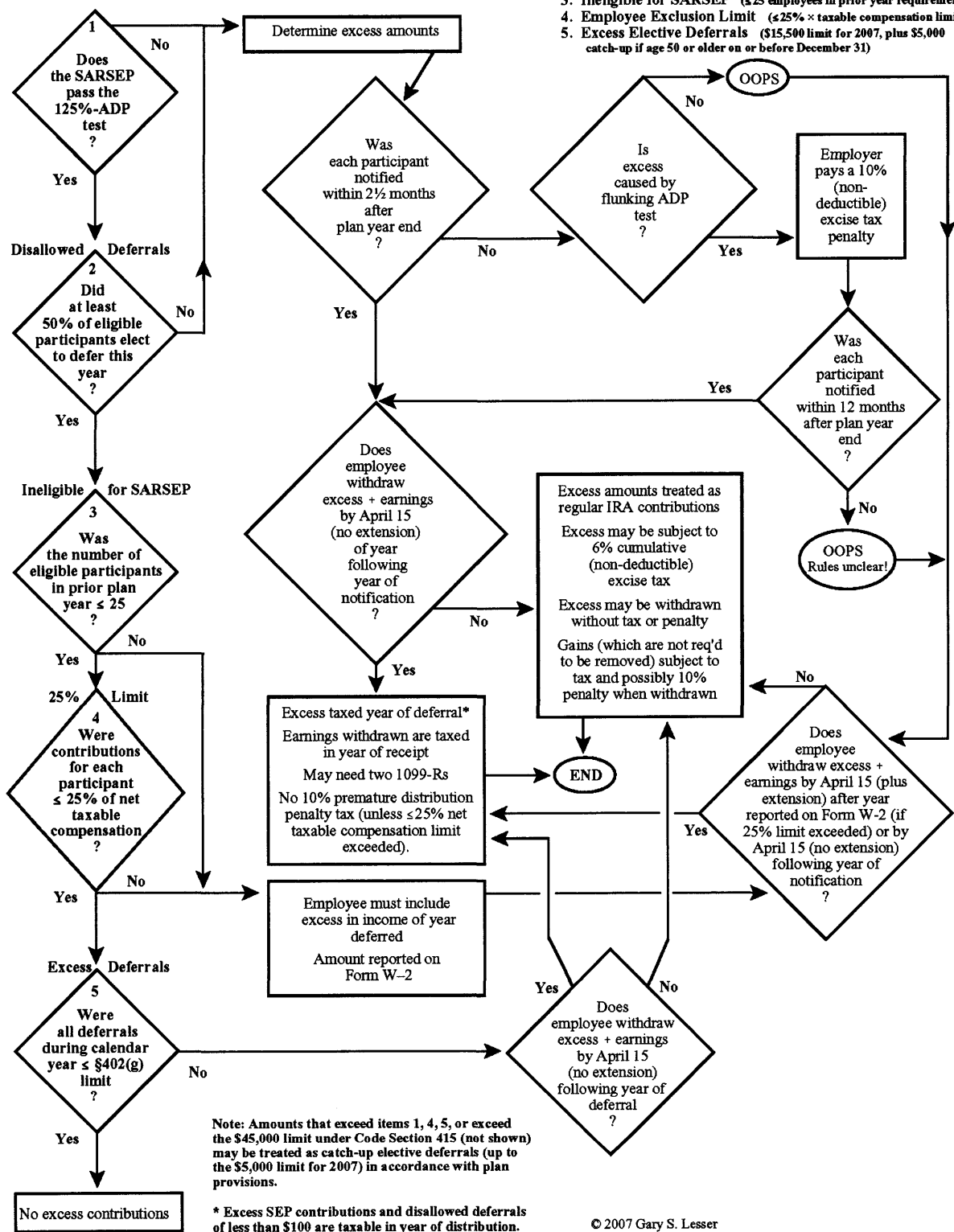
Traditional/Roth IRA Eligibility for 2007



Excess SEP/SARSEP Contributions – 2007

Excess SEP/SARSEP Contributions - 2007

- Key: 1. Excess SEP Contributions (125% ADP test)
 2. Disallowed Deferrals (at least 50% test)
 3. Ineligible for SARSEP (≤ 25 employees in prior year requirement)
 4. Employee Exclusion Limit ($\leq 25\% \times$ taxable compensation limit)
 5. Excess Elective Deferrals (\$15,500 limit for 2007, plus \$5,000 catch-up if age 50 or older on or before December 31)



Plan Feature Comparison Chart Part I

PLAN	KEY ADVANTAGE	SPONSOR/ELIGIBLE EMPLOYER	EMPLOYER'S ROLE	CONTRIBUTORS TO THE PLAN	MAXIMUM ANNUAL CONTRIBUTION (per participant) See www.irs.gov/ep for annual updates.	CATCH-UP CONTRIBUTIONS
Payroll Deduction IRA	easy to set up and maintain	any employer	<ul style="list-style-type: none"> - arrange for employees to make payroll deduction contributions - transmit contributions for employees to IRA - no annual filing requirement 	employee can decide how much to contribute any time	<ul style="list-style-type: none"> employee: - \$4,000 for 2005-2007 - \$5,000 for 2008 	age 50 or over— additional employee contribution - \$1,000 - 2006 and 2007
SEP	easy to set up and maintain	any employer	<ul style="list-style-type: none"> - set up plan - employer may use Form 5305-SEP - transmit contributions for employees to IRA - generally, no annual filing requirement - bank or financial institution handles most of the paperwork 	<ul style="list-style-type: none"> - employer can decide whether to make contributions year-to-year 	up to 25% of compensation but no more than \$45,000 for 2007	N/A
SIMPLE IRA Plan	salary reduction plan with little administrative paperwork	employer with 100 or fewer employees that does not currently maintain another plan	<ul style="list-style-type: none"> - set up plan - employer may use Form 5304-SIMPLE or Form 5305-SIMPLE - transmit contributions for employees to IRA - no annual filing requirement - bank or financial institution handles most paperwork 	<ul style="list-style-type: none"> - employee can decide how much to contribute - employer must make matching contributions or contribute 2% of each employee's compensation 	<ul style="list-style-type: none"> employee: - \$10,000 in 2005 and 2006 employer - \$10,500 in 2007 employer - either match employee contributions 100% of first 3% of compensation (can be reduced to as low as 1% in any 2 of 5 years); or - contribute 2% of each eligible employee's compensation 	age 50 or over— additional employee contribution - \$2,500 - 2006 and 2007
401(k)	permits high level of salary deferrals by employees	<ul style="list-style-type: none"> - any employer - governments, only if plan is established prior to May 1986 	<ul style="list-style-type: none"> - arrange for employees to make payroll reduction contributions and transmit contributions - annual filing of Form 5500 is required (unless government entity) - may require annual nondiscrimination testing to ensure plan does not discriminate in favor of highly compensated employees - a written plan document is required - no model form to establish this plan 	<ul style="list-style-type: none"> - employee salary reduction contributions - employer contributions 	<ul style="list-style-type: none"> employees elective deferrals: - \$15,000 - 2006 - \$15,500 - 2007 employer & employee - lesser of \$45,000 (2007) or 100% of compensation subject to nondiscrimination testing 	age 50 and over—additional employer contribution - \$5,000 - 2006 and 2007

PLAN	KEY ADVANTAGE	SPONSOR/ELIGIBLE EMPLOYER	EMPLOYER'S ROLE	CONTRIBUTORS TO THE PLAN	MAXIMUM ANNUAL CONTRIBUTION (per participant) See www.irs.gov/ep for annual updates.	CATCH-UP CONTRIBUTIONS
403(b)	<ul style="list-style-type: none"> - permits high level of salary deferrals by employees - special catch-up contributions 	<ul style="list-style-type: none"> - public education employers - 501(c)(3) organizations 	<ul style="list-style-type: none"> - arrange for employees to make payroll reduction contributions and transmit contributions - may require Form 5500 filing if employer contributions are made (unless government entity). - no model form to establish this plan 	<ul style="list-style-type: none"> - employee salary reduction contributions - employer contributions 	<ul style="list-style-type: none"> - employee elective deferrals: <ul style="list-style-type: none"> - \$15,000 - 2006 - \$15,500 - 2007 - employer & employee— lesser of \$45,000 (2007) or 100% of compensation age 50 or over— additional employee contribution— \$5,000 (2006 and 2007) 	<ul style="list-style-type: none"> special 403(b) catch-up: <ul style="list-style-type: none"> - selected employers - employee must have 15 years of service - limited to least of: <ol style="list-style-type: none"> 1) \$3,000 2) \$15,000 less previously excluded special catch-ups, and 3) \$5,000 multiplied by years of service minus previously excluded deferrals
457(b) Governmental	<ul style="list-style-type: none"> - permits high level of salary deferrals by employees - special catch-up contributions 	<ul style="list-style-type: none"> - state and local governments 	<ul style="list-style-type: none"> - a written plan document is required - no model form to establish this plan 	<ul style="list-style-type: none"> - employee salary reduction contributions - employer contributions 	<ul style="list-style-type: none"> - employer & employee: <ul style="list-style-type: none"> - \$15,000 - 2006 - \$15,500 - 2007 - age 50 or over— additional employee contribution— \$5,000 (2006 and 2007) 	<ul style="list-style-type: none"> special 457 catch-up: <ul style="list-style-type: none"> - 3 years prior to the year of normal retirement age - limited to lesser of: <ol style="list-style-type: none"> 1) \$31,000 (twice the basic annual limit) for 2007, \$30,000 for 2006, or 2) the basic annual limit plus underutilized basic annual limit in prior years
457(b) Tax-Exempt Organization (Non-Church)	<ul style="list-style-type: none"> - permits high level of salary deferrals by employees - special catch-up contributions 	<ul style="list-style-type: none"> - any tax-exempt organization 	<ul style="list-style-type: none"> - arrange for employees to make payroll reduction contributions - written plan document is required - no model form to establish this plan 	<ul style="list-style-type: none"> - employee salary reduction contributions - employer contributions 	<ul style="list-style-type: none"> - employer & employee: <ul style="list-style-type: none"> - \$15,000 - 2006 - \$15,500 - 2007 - no age 50 or over additional employee contribution 	<ul style="list-style-type: none"> special 457 catch-up: <ul style="list-style-type: none"> - 3 years prior to the year of normal retirement age - limited to lesser of: <ol style="list-style-type: none"> 1) \$31,000 (twice the basic annual limit) for 2007, \$30,000 for 2006, or 2) the basic annual limit plus underutilized basic annual limit in prior years
Defined Benefit	<ul style="list-style-type: none"> - provides a fixed, pre-established benefit for employees 	<ul style="list-style-type: none"> - any employer 	<ul style="list-style-type: none"> - annual filing of Form 5500 required (unless government entity) - an actuary must determine annual contributions - no model form to establish this plan 	<ul style="list-style-type: none"> - primarily funded by employer 	<ul style="list-style-type: none"> - actuarially determined contribution - plan benefits are subject to nondiscrimination testing 	<ul style="list-style-type: none"> - N/A

Plan Feature Comparison Chart Part II

PLAN	MINIMUM EMPLOYEE COVERAGE REQUIREMENT	WITHDRAWALS, LOANS, AND DISTRIBUTIONS	ROLLOVER/TRANSFERS	VESTING	EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM (EPCRS)
Payroll Deduction IRA	should be made available to all employees	<ul style="list-style-type: none"> - withdrawals permitted any time subject to federal income taxes - subject to 10% additional tax if before age 59½ - must start receiving distributions by April 1 of the year following attainment of age 70½ (special rules apply to Roth IRAs) - loans are not permitted from IRAs 	<ul style="list-style-type: none"> - rollovers permitted from one IRA to another and to an eligible retirement plan (special rules apply to Roth IRAs) 	<ul style="list-style-type: none"> - contributions are immediately 100% vested 	no
SEP	must be offered to all employees who are at least 21 years of age, employed by the employer for 3 of the last 5 years, and had compensation of \$500 for 2007; \$450 for 2006	<ul style="list-style-type: none"> - withdrawals permitted any time subject to federal income taxes - subject to 10% additional tax if before age 59½ - must start receiving distributions by April 1 of the year following attainment of age 70½ - loans are not permitted from SEPs 	<ul style="list-style-type: none"> - rollovers permitted from one SEP-IRA to another and to an eligible retirement plan 	<ul style="list-style-type: none"> - contributions are immediately 100% vested 	yes
SIMPLE IRA Plan	must be offered to all employees who have compensation of at least \$5,000 in any prior 2 years, and are reasonably expected to earn at least \$5,000 in the current year	<ul style="list-style-type: none"> - withdrawals permitted any time subject to federal income taxes - subject to 10% additional tax if before age 59½ (25% if less than 2 years of participation) - must start receiving distributions by April 1 of the year following attainment of age 70½ - loans are not permitted from SIMPLE IRA plans 	<ul style="list-style-type: none"> - rollovers permitted from one SIMPLE IRA to another SIMPLE IRA - however, a rollover from a SIMPLE IRA to a non-SIMPLE IRA can be made tax-free only after a 2-year participation in the SIMPLE IRA plan 	<ul style="list-style-type: none"> - employer and employee contributions are immediately 100% vested 	yes
401(k)	must pass minimum coverage test	<ul style="list-style-type: none"> - withdrawals permitted after a distributable event occurs (e.g., retirement, death, disability, severance from employment) - must start receiving distributions by April 1 following the later of date of retirement or attainment of age 70½ - plan may permit loans and hardship withdrawals - early withdrawals subject to 10% additional tax - Qualified Domestic Relations Orders (QDROs) recognized 	<ul style="list-style-type: none"> - Participant's benefits can be rolled over to another qualified plan that accepts rollovers or an IRA 	<ul style="list-style-type: none"> - employee salary deferrals are immediately 100% vested - employer contributions may vest over time according to plan terms 	yes

PLAN	MINIMUM EMPLOYEE COVERAGE REQUIREMENT	WITHDRAWALS, LOANS, AND DISTRIBUTIONS	ROLLOVER/TRANSFERS	VESTING	EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM (EPCRS)
403(b)	<p>salary deferrals:</p> <ul style="list-style-type: none"> - all employees may elect to have a contribution of more than \$200 by salary reduction other contributions - must pass minimum coverage test (except government entities) 	<ul style="list-style-type: none"> - withdrawals permitted after a distributable event occurs (e.g., retirement, death, disability, severance from employment) - must start receiving distributions by April 1 following the later of date of retirement or attainment of age 70½ - plan may permit loans and hardship withdrawals - early withdrawals subject to 10% additional tax - Qualified Domestic Relations Orders (QDROs) recognized 	<ul style="list-style-type: none"> - rollovers permitted to eligible retirement plan - transfers permitted from one 403(b) to another 403(b) - purchase permissive service (government plans) 	<ul style="list-style-type: none"> - employee salary deferrals are immediately 100% vested - employer contributions may vest over time according to plan terms 	<p>yes</p>
457(b)	<ul style="list-style-type: none"> - common-law employees - independent contractors 	<ul style="list-style-type: none"> - withdrawals permitted after severance from employment - must start receiving distributions by April 1 following the later of date of retirement or attainment of age 70½ - plan may permit loans and distribution for unforeseen emergency or small inactive accounts - Qualified Domestic Relations Orders (QDROs) recognized 	<ul style="list-style-type: none"> - rollovers permitted to eligible retirement plan - transfers permitted from one government 457(b) to another government 457(b) - purchase permissive service 	<ul style="list-style-type: none"> - employee salary deferrals are immediately 100% vested - employer contributions may vest over time according to plan terms 	<ul style="list-style-type: none"> - no - special 180-day rule to correct for government - submission accepted on a provisional basis outside EPCRS
457(b) Tax-Exempt Organization (Non-Church)	<ul style="list-style-type: none"> - selected group of management or highly compensated employees - independent contractors 	<ul style="list-style-type: none"> - withdrawals permitted after severance from employment - must start receiving distributions by April 1 following the later of date of retirement or attainment of age 70½ - plan may not permit loans - special rules apply to independent contractors - Qualified Domestic Relations Orders (QDROs) recognized 	<ul style="list-style-type: none"> - no rollovers permitted - post-severance transfers permitted from one tax-exempt 457(b) to another 457(b) 	<ul style="list-style-type: none"> - employee and employer contributions must be subject to claims of creditors 	<ul style="list-style-type: none"> - no - submission accepted on a provisional basis outside EPCRS
Defined Benefit	<ul style="list-style-type: none"> - must pass minimum coverage test 	<ul style="list-style-type: none"> - payment of benefits after a distributable event occurs (e.g., retirement, death, disability, severance from employment) - must start receiving distributions by April 1 following the later of date of retirement or attainment of age 70½ - loans permitted except for fully insured plans - early withdrawals subject to 10% additional tax - Qualified Domestic Relations Orders (QDROs) recognized 	<ul style="list-style-type: none"> - generally, participant's benefit can be rolled over to another qualified plan that accepts rollovers or an IRA 	<ul style="list-style-type: none"> - may vest over time according to plan terms 	<p>yes</p>

Retirement Plan Rollover Chart

		ROLLOVER TO						2008						
		2007	403(b) Plan	457(b) Plan	Thrift Savings Plan	Traditional IRA	SEP IRA	SIMPLE IRA	Roth IRA	Coverdell ESA	Designated Roth Account (DRA)			
R O L L O V E R F R O M	ROLLOVER CHART	Qualified Plan	YES, if plan accepts. If rollover is after tax, it must be a direct rollover.	YES, if plan accepts. If rollover is after tax, it must be a direct rollover.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if contribution is after tax, Form 8606 is required.	NO	YES, after 2007, direct conversion allowed.	NO	NO
	403(b) Plan	YES, if plan accepts. If rollover is after tax, it must be a direct rollover.	YES, if plan accepts. If rollover is after tax, it must be a direct rollover.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if contribution is after tax, Form 8606 is required.	YES, if contribution is after tax, Form 8606 is required.	NO	YES, after 2007, direct conversion allowed.	NO	NO
	457(b) Plan	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if contribution is after tax, Form 8606 is required.	YES, if contribution is after tax, Form 8606 is required.	NO	YES, after 2007, direct conversion allowed.	NO	NO
	Thrift Savings Plan	YES	YES	YES	NO, see Form TSP-65	YES	YES	YES	YES	YES	NO	NO	NO	NO
	Conduit IRA	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, but taxpayer should keep conduit IRA separate.	YES, but taxpayer should keep conduit IRA separate.	YES, but taxpayer should keep conduit IRA separate.	YES, but taxpayer should keep conduit IRA separate.	YES, but taxpayer should keep conduit IRA separate.	NO	YES, as a conversion.	NO	NO
	Traditional IRA	YES, if plan accepts.	YES, if plan accepts.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES, if plan accepts. No rollover of after-tax contributions allowed.	YES	YES	YES	YES	YES	NO	YES, as a conversion.	NO	NO
	SIMPLE IRA	YES, if plan accepts; only after 2 years.	YES, if plan accepts; only after 2 years.	YES, if plan accepts; only after 2 years.	YES, only after 2 years.	YES, only after 2 years.	YES, only after 2 years.	YES, only after 2 years.	YES, only after 2 years.	YES, only after 2 years.	YES	YES, as a conversion after 2 years.	NO	NO
	Roth IRA	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	YES	NO	NO
	Coverdell ESA	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	YES	NO
	Designated Roth Account (DRA)	NO	NO	NO	NO	NO	NO	NO	NO	NO	NO	YES	NO	YES

Appendix B Plan Illustrations

Simple IRA Plan for a Corporation

SIMPLE PLANS (see Chapter 3)		SIMPLE ILLUSTRATOR		SIMPLE IRA PLAN for a Corporation		CONTRIBUTION		16-Feb-2007				
SIMPLE IRA		Prepared by: Giant Financial Organization #1		MATCHING		CONTRIBUTION						
Year	Owner	IF	2	3	UP	TO	3					
Eligible Employees	Birth	Enter	Pre-Plan W-2 Compensation	Enter	Salary Reduction Amount	Salary Reduction Amount	W-2 Compensation	Matching Amounts	Total SIMPLE Contribution	Taxable Income		
Year	Owner	IF	2	3	UP	TO	3					
2007	<- Plan Year	3.00%	<- General Matching	C	Entity Type (C, P, or S)	C	Corporation					
1.50%	<- Alternate Matching	P	Partnership or LLC									
I	<- SIMPLE IRA	S	Sole-Proprietorship									
Y	<- Catch-Up											
Year	Owner	IF	2	3	UP	TO	3					
Eligible Employees	Birth	Enter	Pre-Plan W-2 Compensation	Enter	Salary Reduction Amount	Salary Reduction Amount	W-2 Compensation	Matching Amounts	Total SIMPLE Contribution	Taxable Income		
Catch-Up Amt	\$2,500	Totals:	\$1,720,000.00	Col. n/a	0.000%	0.999 if K	\$116,500.00	\$1,720,000.00	\$44,200.00	\$160,700.00		
1	Jim Shine	1940	o	\$300,000.00	0.000%	0.999 Max	1	\$13,000.00	\$300,000.00	\$9,000.00	\$22,000.00	\$287,000.00
2	Paul Ray	1950	o	\$250,000.00	0.000%	0.999 Max	2	\$13,000.00	\$250,000.00	\$7,500.00	\$20,500.00	\$237,000.00
3	Dan Karp	1950	n	\$200,000.00	0.000%	3000.000 <- \$	3	\$3,000.00	\$200,000.00	\$3,000.00	\$6,000.00	\$197,000.00
4	Jim Sleig	1948	n	\$100,000.00	0.000%	0.300 <- %	4	\$13,000.00	\$100,000.00	\$3,000.00	\$16,000.00	\$87,000.00
5	Ted Hand	1949	n	\$90,000.00	0.000%	0.050 <- %	5	\$4,500.00	\$90,000.00	\$2,700.00	\$7,200.00	\$85,500.00
6	Sue Mock	1950	n	\$80,000.00	0.000%	0.050 <- %	6	\$4,000.00	\$80,000.00	\$2,400.00	\$6,400.00	\$76,000.00
7	Fred Quak	1951	n	\$70,000.00	0.000%	0.100 <- %	7	\$7,000.00	\$70,000.00	\$2,100.00	\$9,100.00	\$63,000.00
8	Tony Nutt	1952	n	\$60,000.00	0.000%	0.100 <- %	8	\$6,000.00	\$60,000.00	\$1,800.00	\$7,800.00	\$54,000.00
9	Ned Elms	1953	n	\$50,000.00	0.000%	0.100 <- %	9	\$5,000.00	\$50,000.00	\$1,500.00	\$6,500.00	\$45,000.00
10	Mo Fox	1954	n	\$50,000.00	0.000%	0.000%	10	\$0.00	\$50,000.00	\$0.00	\$0.00	\$50,000.00
11	Ken Dieh	1955	n	\$50,000.00	0.000%	0.000%	11	\$0.00	\$50,000.00	\$0.00	\$0.00	\$50,000.00
12	Dan Knor	1956	n	\$40,000.00	0.000%	0.100 <- %	12	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00	\$36,000.00
13	Ted Biel	1950	n	\$40,000.00	0.000%	0.100 <- %	13	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00	\$36,000.00
14	Uma Hand	1951	n	\$40,000.00	0.000%	1000.000 <- \$	14	\$1,000.00	\$40,000.00	\$1,000.00	\$2,000.00	\$39,000.00
15	Jim Tooth	1952	n	\$40,000.00	0.000%	0.100 <- %	15	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00	\$36,000.00
16	Lydia Arm	1953	n	\$40,000.00	0.000%	0.150 <- %	16	\$6,000.00	\$40,000.00	\$1,200.00	\$7,200.00	\$34,000.00
17	Greg Shug	1954	n	\$50,000.00	0.000%	0.200 <- %	17	\$10,000.00	\$50,000.00	\$1,500.00	\$11,500.00	\$40,000.00
18	Fran Poe	1960	n	\$30,000.00	0.000%	0.000%	18	\$0.00	\$30,000.00	\$0.00	\$0.00	\$30,000.00
17	Gary Red	1961	n	\$30,000.00	0.000%	0.050 <- %	19	\$1,500.00	\$30,000.00	\$900.00	\$2,400.00	\$28,500.00
20	Myra Ing	1962	n	\$30,000.00	0.000%	0.100 <- %	20	\$3,000.00	\$30,000.00	\$900.00	\$3,900.00	\$27,000.00
21	Larry Bo	1950	n	\$20,000.00	0.000%	0.050 <- %	21	\$1,000.00	\$20,000.00	\$600.00	\$1,600.00	\$19,000.00
22	Rose Gri	1950	n	\$20,000.00	0.000%	0.100 <- %	22	\$2,000.00	\$20,000.00	\$600.00	\$2,600.00	\$18,000.00
23	Bill Hoot	1950	n	\$10,000.00	0.000%	0.000%	23	\$0.00	\$10,000.00	\$0.00	\$0.00	\$10,000.00
24	Jim Red	1950	n	\$10,000.00	0.000%	0.050 <- %	24	\$500.00	\$10,000.00	\$300.00	\$800.00	\$9,500.00
25	Sam Toe	1950	n	\$10,000.00	0.000%	0.100 <- %	25	\$1,000.00	\$10,000.00	\$300.00	\$1,300.00	\$9,000.00
26	Bill Huff	1950	n	\$10,000.00	0.000%	0.999 Max	26	\$10,000.00	\$10,000.00	\$300.00	\$10,300.00	\$0.00

401(k) SIMPLE Plan for a Corporation

16-Feb-2007

401(k) SIMPLE PLAN for a Corporation

CONTRIBUTION

16-Feb-2007

401(k) SIMPLE PLAN for a Corporation

Prepared by: Giant Financial Organization #1 - M A T C H I N G C O N T R I B U T I O N

2007 <- Plan Year
 3.00% <- General Matching
 1.50% <- Alt. Matching - N/A
 K <- 401(k) SIMPLE
 Y <- Catch-Up

Entity Type (C, P, or S)
 C = Corporation
 P = Partnership or LLC
 S = Sole-Proprietorship

Take Home Salary
 2 <- n/a or Desired
 Salary Reduction Amount
 \$ or % or .999 if K

Pre-Plan W-2 Compensation
 Enter
 Compensation

Col. n/a
 Catch-Up Amt \$2,500 Totals: \$1,720,000.00

W-2 Compensation
 W-2 Compensation

Matching Total SIMPLE
 Amounts Contribution

Taxable Income
 Taxable Income

Net IRC 415
 Limit

Eligible Employees	Year of Birth	Year Entered	Pre-Plan W-2 Compensation	Enter Compensation	Col. n/a	Take Home Salary Reduction Amount	Salary Reduction Amount	W-2 Compensation	Matching Total SIMPLE Amounts Contribution	Taxable Income	Net IRC 415 Limit	
1 Jim Shine	1940	n	\$300,000.00	\$300,000.00	0.000%	0.000%	0.999 Max	\$300,000.00	\$6,750.00	\$19,750.00	\$287,000.00	\$225,000
2 Paul Ray	1950	n	\$250,000.00	\$250,000.00	0.000%	0.000%	0.999 Max	\$250,000.00	\$6,750.00	\$19,750.00	\$237,000.00	\$225,000
3 Dan Karp	1950	n	\$200,000.00	\$200,000.00	0.000%	0.000%	3000.000 <- \$	\$3,000.00	\$6,000.00	\$19,000.00	\$197,000.00	\$200,000
4 Jim Steig	1948	n	\$100,000.00	\$100,000.00	0.000%	0.000%	0.300 <- %	\$3,000.00	\$16,000.00	\$16,000.00	\$87,000.00	\$102,500
5 Ted Hand	1949	n	\$90,000.00	\$90,000.00	0.000%	0.000%	0.050 <- %	\$4,500.00	\$7,200.00	\$7,200.00	\$85,500.00	\$90,000
6 Sue Meck	1950	n	\$80,000.00	\$80,000.00	0.000%	0.000%	0.050 <- %	\$4,000.00	\$6,400.00	\$6,400.00	\$76,000.00	\$80,000
7 Fred Quak	1951	n	\$70,000.00	\$70,000.00	0.000%	0.000%	0.100 <- %	\$7,000.00	\$9,100.00	\$9,100.00	\$63,000.00	\$70,000
8 Tony Nutt	1952	n	\$60,000.00	\$60,000.00	0.000%	0.000%	0.100 <- %	\$6,000.00	\$7,800.00	\$7,800.00	\$54,000.00	\$60,000
9 Ned Elms	1953	n	\$50,000.00	\$50,000.00	0.000%	0.000%	0.100 <- %	\$5,000.00	\$6,500.00	\$6,500.00	\$45,000.00	\$50,000
10 Mo Fox	1954	n	\$50,000.00	\$50,000.00	0.000%	0.000%	0.000	\$0.00	\$0.00	\$0.00	\$50,000.00	\$50,000
11 Ken Dieh	1955	n	\$50,000.00	\$50,000.00	0.000%	0.000%	0.000	\$0.00	\$0.00	\$0.00	\$50,000.00	\$50,000
12 Dan Koor	1956	n	\$40,000.00	\$40,000.00	0.000%	0.000%	0.100 <- %	\$4,000.00	\$1,200.00	\$5,200.00	\$36,000.00	\$40,000
13 Ted Biel	1950	n	\$40,000.00	\$40,000.00	0.000%	0.000%	0.100 <- %	\$4,000.00	\$1,200.00	\$5,200.00	\$36,000.00	\$40,000
14 Ulma Hand	1951	n	\$40,000.00	\$40,000.00	0.000%	0.000%	1000.000 <- \$	\$1,000.00	\$2,000.00	\$2,000.00	\$39,000.00	\$40,000
15 Jim Tooth	1952	n	\$40,000.00	\$40,000.00	0.000%	0.000%	0.100 <- %	\$4,000.00	\$1,200.00	\$5,200.00	\$36,000.00	\$40,000
16 Lydia Arm	1953	n	\$40,000.00	\$40,000.00	0.000%	0.000%	0.150 <- %	\$6,000.00	\$7,200.00	\$7,200.00	\$34,000.00	\$40,000
17 Greg Shug	1954	n	\$50,000.00	\$50,000.00	0.000%	0.000%	0.200 <- %	\$10,000.00	\$11,500.00	\$11,500.00	\$40,000.00	\$50,000
18 Fran Poe	1960	n	\$30,000.00	\$30,000.00	0.000%	0.000%	0.000	\$0.00	\$0.00	\$0.00	\$30,000.00	\$30,000
17 Gary Red	1961	n	\$30,000.00	\$30,000.00	0.000%	0.000%	0.050 <- %	\$1,500.00	\$900.00	\$2,400.00	\$28,500.00	\$30,000
20 Myra Ing	1962	n	\$30,000.00	\$30,000.00	0.000%	0.000%	0.100 <- %	\$3,000.00	\$900.00	\$3,900.00	\$27,000.00	\$30,000
21 Larry Bo	1950	n	\$20,000.00	\$20,000.00	0.000%	0.000%	0.050 <- %	\$1,000.00	\$600.00	\$1,600.00	\$19,000.00	\$20,000
22 Rose Grie	1950	n	\$20,000.00	\$20,000.00	0.000%	0.000%	0.100 <- %	\$2,000.00	\$600.00	\$2,600.00	\$18,000.00	\$20,000
23 Bill Hoot	1950	n	\$10,000.00	\$10,000.00	0.000%	0.000%	0.000	\$0.00	\$0.00	\$0.00	\$10,000.00	\$10,000
24 Jim Red	1950	n	\$10,000.00	\$10,000.00	0.000%	0.000%	0.050 <- %	\$500.00	\$300.00	\$800.00	\$9,500.00	\$10,000
25 Sam Toe	1950	n	\$10,000.00	\$10,000.00	0.000%	0.000%	0.100 <- %	\$1,000.00	\$300.00	\$1,300.00	\$9,000.00	\$10,000
26 Bill Huff	1950	n	\$10,000.00	\$10,000.00	0.000%	0.000%	0.999 Max	\$9,700.00	\$300.00	\$10,000.00	\$300.00	\$10,000

SIMPLE PLANS (see Chapter 3)

401(k) SIMPLE PLAN for a Corporation

ALTERNATIVE MATCHING

NON-SELECTIVE CONTRIBUTION

2.00% -- Statutory rate.
 59.93% <- Owner % of Total E/er
 27.78% <- Owner % of Nonselective
 \$35,000.00 <- Owner Total
 \$113,700.00 <- Nonowner Total
 \$148,700.00 <- Plan Total

>> OPTION NOT AVAILABLE IN 401(k)

#	401(k) SIMPLE	415	Tick	Hide	COL	Salary	W-2	Non-Selective	Min. Comp.	Total SIMPLE	Contribution	Contribution	Income	Taxable
						Reduction	Compensation	Contribution	Contribution	Total SIMPLE	Contribution	Contribution	Income	Income
0	\$116,300.00	\$1,720,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$287,000.00	\$17,500.00	\$287,000.00	\$17,500.00	\$287,000.00	\$287,000.00	\$287,000.00	\$287,000.00	\$287,000.00
1	\$13,000.00	\$300,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$237,000.00	\$17,500.00	\$237,000.00	\$17,500.00	\$237,000.00	\$237,000.00	\$237,000.00	\$237,000.00	\$237,000.00
2	\$13,000.00	\$250,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$197,000.00	\$17,500.00	\$197,000.00	\$17,500.00	\$197,000.00	\$197,000.00	\$197,000.00	\$197,000.00	\$197,000.00
3	\$3,000.00	\$200,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$157,000.00	\$17,500.00	\$157,000.00	\$17,500.00	\$157,000.00	\$157,000.00	\$157,000.00	\$157,000.00	\$157,000.00
4	\$13,000.00	\$100,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$85,500.00	\$17,500.00	\$85,500.00	\$17,500.00	\$85,500.00	\$85,500.00	\$85,500.00	\$85,500.00	\$85,500.00
5	\$4,500.00	\$90,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$76,000.00	\$17,500.00	\$76,000.00	\$17,500.00	\$76,000.00	\$76,000.00	\$76,000.00	\$76,000.00	\$76,000.00
6	\$4,000.00	\$80,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$63,000.00	\$17,500.00	\$63,000.00	\$17,500.00	\$63,000.00	\$63,000.00	\$63,000.00	\$63,000.00	\$63,000.00
7	\$7,000.00	\$70,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$54,000.00	\$17,500.00	\$54,000.00	\$17,500.00	\$54,000.00	\$54,000.00	\$54,000.00	\$54,000.00	\$54,000.00
8	\$6,000.00	\$60,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$45,000.00	\$17,500.00	\$45,000.00	\$17,500.00	\$45,000.00	\$45,000.00	\$45,000.00	\$45,000.00	\$45,000.00
9	\$5,000.00	\$50,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$36,000.00	\$17,500.00	\$36,000.00	\$17,500.00	\$36,000.00	\$36,000.00	\$36,000.00	\$36,000.00	\$36,000.00
10	\$0.00	\$0.00	\$4,500.00	\$4,500.00	\$17,500.00	\$0.00	\$17,500.00	\$0.00	\$17,500.00	\$0.00	\$17,500.00	\$0.00	\$17,500.00	\$0.00
11	\$0.00	\$0.00	\$4,500.00	\$4,500.00	\$17,500.00	\$0.00	\$17,500.00	\$0.00	\$17,500.00	\$0.00	\$17,500.00	\$0.00	\$17,500.00	\$0.00
12	\$4,000.00	\$40,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$36,000.00	\$17,500.00	\$36,000.00	\$17,500.00	\$36,000.00	\$36,000.00	\$36,000.00	\$36,000.00	\$36,000.00
13	\$4,000.00	\$40,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$36,000.00	\$17,500.00	\$36,000.00	\$17,500.00	\$36,000.00	\$36,000.00	\$36,000.00	\$36,000.00	\$36,000.00
14	\$1,000.00	\$40,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$39,000.00	\$17,500.00	\$39,000.00	\$17,500.00	\$39,000.00	\$39,000.00	\$39,000.00	\$39,000.00	\$39,000.00
15	\$4,000.00	\$40,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$36,000.00	\$17,500.00	\$36,000.00	\$17,500.00	\$36,000.00	\$36,000.00	\$36,000.00	\$36,000.00	\$36,000.00
16	\$6,000.00	\$40,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$34,000.00	\$17,500.00	\$34,000.00	\$17,500.00	\$34,000.00	\$34,000.00	\$34,000.00	\$34,000.00	\$34,000.00
17	\$10,000.00	\$50,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$40,000.00	\$17,500.00	\$40,000.00	\$17,500.00	\$40,000.00	\$40,000.00	\$40,000.00	\$40,000.00	\$40,000.00
18	\$0.00	\$30,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$30,000.00	\$17,500.00	\$30,000.00	\$17,500.00	\$30,000.00	\$30,000.00	\$30,000.00	\$30,000.00	\$30,000.00
19	\$1,500.00	\$30,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$28,500.00	\$17,500.00	\$28,500.00	\$17,500.00	\$28,500.00	\$28,500.00	\$28,500.00	\$28,500.00	\$28,500.00
20	\$3,000.00	\$30,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$27,000.00	\$17,500.00	\$27,000.00	\$17,500.00	\$27,000.00	\$27,000.00	\$27,000.00	\$27,000.00	\$27,000.00
21	\$1,000.00	\$20,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$19,000.00	\$17,500.00	\$19,000.00	\$17,500.00	\$19,000.00	\$19,000.00	\$19,000.00	\$19,000.00	\$19,000.00
22	\$2,000.00	\$20,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$18,000.00	\$17,500.00	\$18,000.00	\$17,500.00	\$18,000.00	\$18,000.00	\$18,000.00	\$18,000.00	\$18,000.00
23	\$0.00	\$10,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$10,000.00	\$17,500.00	\$10,000.00	\$17,500.00	\$10,000.00	\$10,000.00	\$10,000.00	\$10,000.00	\$10,000.00
24	\$500.00	\$10,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$9,500.00	\$17,500.00	\$9,500.00	\$17,500.00	\$9,500.00	\$9,500.00	\$9,500.00	\$9,500.00	\$9,500.00
25	\$1,000.00	\$10,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$9,000.00	\$17,500.00	\$9,000.00	\$17,500.00	\$9,000.00	\$9,000.00	\$9,000.00	\$9,000.00	\$9,000.00
26	\$9,800.00	\$10,000.00	\$4,500.00	\$4,500.00	\$17,500.00	\$200.00	\$17,500.00	\$200.00	\$17,500.00	\$200.00	\$200.00	\$200.00	\$200.00	\$200.00

Simple IRA Plan for a Partnership

16-Feb-2007

SIMPLE IRA PLAN for a Partnership

SIMPLE ILLUSTRATOR

Prepared by: Giant Financial Organization #1 --- M A T C H I N G C O N T R I B U T I O N ---

S I M P L E I R A

All Partners and Eligible Employees	Year of Birth	If Owner Enter "o"	Pre-Plan W-2 Compensation or Owner Net SE Income	Calculation of Owners Percentage	2 <- Auto Exp. Share Percentage	SE Owner Salary Reduction Amount	Take Home or Desired Salary Reduction Amount \$ or % or	UP TO 3 % SIMPLE I R A	W-2 Income/ .9235 NESE after 3% or \$27,700.00 Nonowner Allocation	Matching Amounts	Total SIMPLE Contribution	Owner % of Total E/er	Owner % of Matching	Nonowner Total	Plan Total	Taxable Income
Catch-Up Amt \$2,500 Totals:			\$1,720,000.00					#	\$116,500.00	\$1,652,344.05	\$42,170.32	\$158,670.32				
1 Jim Shine	1940	o	\$300,000.00	0.0000%	54.545%	0.999 Max	1 \$13,000.00	1	\$13,000.00	\$263,096.75	\$7,892.90	\$20,892.90	59.37%		\$242,203.86	
2 Paul Ray	1950	o	\$250,000.00	0.0000%	45.455%	0.999 Max	2 \$13,000.00	2	\$13,000.00	\$219,247.30	\$6,577.42	\$19,577.42	34.31%		\$199,669.88	
3 Dan Karp	1950	n	\$200,000.00	0.0000%	0.000%	3000.000 <- \$	3 \$3,000.00	3	\$3,000.00	\$200,000.00	\$3,000.00	\$6,000.00			\$197,000.00	
4 Jim Sleig	1948	n	\$100,000.00	0.0000%	0.000%	0.300 <- %	4 \$13,000.00	4	\$13,000.00	\$100,000.00	\$3,000.00	\$16,000.00			\$87,000.00	
5 Ted Hand	1949	n	\$90,000.00	0.0000%	0.000%	0.050 <- %	5 \$4,500.00	5	\$4,500.00	\$90,000.00	\$2,700.00	\$7,200.00			\$85,500.00	
6 Sue Mock	1950	n	\$80,000.00	0.0000%	0.000%	0.050 <- %	6 \$4,000.00	6	\$4,000.00	\$80,000.00	\$2,400.00	\$6,400.00			\$76,000.00	
7 Fred Quak	1951	n	\$70,000.00	0.0000%	0.000%	0.100 <- %	7 \$7,000.00	7	\$7,000.00	\$70,000.00	\$2,100.00	\$9,100.00			\$63,000.00	
8 Tony Nutt	1952	n	\$60,000.00	0.0000%	0.000%	0.100 <- %	8 \$6,000.00	8	\$6,000.00	\$60,000.00	\$1,800.00	\$7,800.00			\$54,000.00	
9 Ned Elms	1953	n	\$50,000.00	0.0000%	0.000%	0.100 <- %	9 \$5,000.00	9	\$5,000.00	\$50,000.00	\$1,500.00	\$6,500.00			\$45,000.00	
10 Mo Fox	1954	n	\$50,000.00	0.0000%	0.000%	0.000%	10 \$0.00	10	\$0.00	\$50,000.00	\$0.00	\$0.00			\$50,000.00	
11 Ken Dieh	1955	n	\$50,000.00	0.0000%	0.000%	0.000%	11 \$0.00	11	\$0.00	\$50,000.00	\$0.00	\$0.00			\$50,000.00	
12 Dan Knor	1956	n	\$40,000.00	0.0000%	0.000%	0.100 <- %	12 \$4,000.00	12	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00			\$36,000.00	
13 Ted Biel	1950	n	\$40,000.00	0.0000%	0.000%	0.100 <- %	13 \$4,000.00	13	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00			\$36,000.00	
14 Ulma Hand	1951	n	\$40,000.00	0.0000%	0.000%	1000.000 <- \$	14 \$1,000.00	14	\$1,000.00	\$40,000.00	\$1,000.00	\$2,000.00			\$39,000.00	
15 Jim Tooth	1952	n	\$40,000.00	0.0000%	0.000%	0.100 <- %	15 \$4,000.00	15	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00			\$36,000.00	
16 Lydia Arm	1953	n	\$40,000.00	0.0000%	0.000%	0.150 <- %	16 \$6,000.00	16	\$6,000.00	\$40,000.00	\$1,200.00	\$7,200.00			\$34,000.00	
17 Greg Snug	1954	n	\$50,000.00	0.0000%	0.000%	0.200 <- %	17 \$10,000.00	17	\$10,000.00	\$50,000.00	\$1,500.00	\$11,500.00			\$40,000.00	
18 Fran Poe	1960	n	\$30,000.00	0.0000%	0.000%	0.000%	18 \$0.00	18	\$0.00	\$30,000.00	\$0.00	\$0.00			\$30,000.00	
17 Gary Red	1961	n	\$30,000.00	0.0000%	0.000%	0.050 <- %	19 \$1,500.00	19	\$1,500.00	\$30,000.00	\$900.00	\$2,400.00			\$28,500.00	
20 Myra Ing	1962	n	\$30,000.00	0.0000%	0.000%	0.100 <- %	20 \$3,000.00	20	\$3,000.00	\$30,000.00	\$900.00	\$3,900.00			\$27,000.00	
21 Larry Bo	1950	n	\$20,000.00	0.0000%	0.000%	0.050 <- %	21 \$1,000.00	21	\$1,000.00	\$20,000.00	\$600.00	\$1,600.00			\$19,000.00	
22 Rose Grie	1950	n	\$20,000.00	0.0000%	0.000%	0.100 <- %	22 \$2,000.00	22	\$2,000.00	\$20,000.00	\$600.00	\$2,600.00			\$18,000.00	
23 Bill Hoot	1950	n	\$10,000.00	0.0000%	0.000%	0.000%	23 \$0.00	23	\$0.00	\$10,000.00	\$0.00	\$0.00			\$10,000.00	
24 Jim Red	1950	n	\$10,000.00	0.0000%	0.000%	0.050 <- %	24 \$500.00	24	\$500.00	\$10,000.00	\$300.00	\$800.00			\$9,500.00	
25 Sam Toe	1950	n	\$10,000.00	0.0000%	0.000%	0.100 <- %	25 \$1,000.00	25	\$1,000.00	\$10,000.00	\$300.00	\$1,300.00			\$9,000.00	
26 Bill Huff	1950	n	\$10,000.00	0.0000%	0.000%	0.999 Max	26 \$10,000.00	26	\$10,000.00	\$10,000.00	\$300.00	\$10,300.00			\$0.00	

401(k) SIMPLE Plan for a Partnership

16-Feb-2007

401(k) SIMPLE PLAN for a Partnership

401(k) SIMPLE PLAN for a Partnership

401(k) SIMPLE PLAN for a Partnership

Prepared by: Giant Financial Organization #1 _ _ _ M A T C H I N G C O N T R I B U T I O N _ _ _ _ _

All Partners And Eligible Employees	Year of Birth	Plan Year	Pre-Plan W-2 Compensation or Owner Net SE Income	If Owner Enter "0"	Calculation of Owners Percentage	SE Owner Exp. Share Percentage	Take Home or Desired Salary Reduction Amount \$ or % or	401(k) SIMPLE Reduction Amount	W-2 Income/ .9235 NESE after 3% or \$27,700.00 Nonowner Allocation	Matching Amounts	Total SIMPLE Contribution	Owner % of Total E/er 32.48% <- Owner % of Matching 58.67% <- Owner % of Total E/er	Taxable Income	Net IRC 415 Limit
Catch-Up Amt \$2,500 Totals:														
1 Jim Shine	1940	0	\$300,000.00	0	0.0000%	54.545%	0.999	1	\$116,200.00	\$1,652,344.05	\$41,027.42	\$157,227.42	\$243,346.76	\$225,000
2 Paul Ray	1950	0	\$250,000.00	0	0.0000%	45.455%	0.999	2	\$13,000.00	\$263,096.75	\$6,750.00	\$19,750.00	\$199,669.88	\$221,747
3 Dan Karp	1950	n	\$200,000.00	0	0.0000%	0.000%	3000.000 <- \$	3	\$3,000.00	\$200,000.00	\$3,000.00	\$6,000.00	\$197,000.00	\$200,000
4 Jim Sleig	1948	n	\$100,000.00	0	0.0000%	0.000%	0.300 <- %	4	\$13,000.00	\$100,000.00	\$3,000.00	\$16,000.00	\$87,000.00	\$102,500
5 Ted Hand	1949	n	\$90,000.00	0	0.0000%	0.000%	0.050 <- %	5	\$4,500.00	\$90,000.00	\$2,700.00	\$7,200.00	\$85,500.00	\$90,000
6 Sue Mock	1950	n	\$80,000.00	0	0.0000%	0.000%	0.050 <- %	6	\$4,000.00	\$80,000.00	\$2,400.00	\$6,400.00	\$76,000.00	\$80,000
7 Fred Quak	1951	n	\$70,000.00	0	0.0000%	0.000%	0.100 <- %	7	\$7,000.00	\$70,000.00	\$2,100.00	\$9,100.00	\$63,000.00	\$70,000
8 Tony Nutt	1952	n	\$60,000.00	0	0.0000%	0.000%	0.100 <- %	8	\$6,000.00	\$60,000.00	\$1,800.00	\$7,800.00	\$54,000.00	\$60,000
9 Ned Elms	1953	n	\$50,000.00	0	0.0000%	0.000%	0.100 <- %	9	\$5,000.00	\$50,000.00	\$1,500.00	\$6,500.00	\$45,000.00	\$50,000
10 Mo Fox	1954	n	\$50,000.00	0	0.0000%	0.000%	0.000	10	\$0.00	\$50,000.00	\$0.00	\$0.00	\$50,000.00	\$50,000
11 Ken Dieh	1955	n	\$50,000.00	0	0.0000%	0.000%	0.000	11	\$0.00	\$50,000.00	\$0.00	\$0.00	\$50,000.00	\$50,000
12 Dan Koor	1956	n	\$40,000.00	0	0.0000%	0.000%	0.100 <- %	12	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00	\$36,000.00	\$40,000
13 Ted Biel	1950	n	\$40,000.00	0	0.0000%	0.000%	0.100 <- %	13	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00	\$36,000.00	\$40,000
14 Ulma Hand	1951	n	\$40,000.00	0	0.0000%	0.000%	1000.000 <- \$	14	\$1,000.00	\$40,000.00	\$1,000.00	\$2,000.00	\$39,000.00	\$40,000
15 Jim Tooth	1952	n	\$40,000.00	0	0.0000%	0.000%	0.100 <- %	15	\$4,000.00	\$40,000.00	\$1,200.00	\$5,200.00	\$36,000.00	\$40,000
16 Lydia Arm	1953	n	\$40,000.00	0	0.0000%	0.000%	0.150 <- %	16	\$6,000.00	\$40,000.00	\$1,200.00	\$7,200.00	\$34,000.00	\$40,000
17 Greg Snug	1954	n	\$50,000.00	0	0.0000%	0.000%	0.200 <- %	17	\$10,000.00	\$50,000.00	\$1,500.00	\$11,500.00	\$40,000.00	\$50,000
18 Fran Poe	1960	n	\$30,000.00	0	0.0000%	0.000%	0.000	18	\$0.00	\$30,000.00	\$0.00	\$0.00	\$30,000.00	\$30,000
17 Gary Red	1961	n	\$30,000.00	0	0.0000%	0.000%	0.050 <- %	19	\$1,500.00	\$30,000.00	\$900.00	\$2,400.00	\$28,500.00	\$30,000
20 Myra Ing	1962	n	\$30,000.00	0	0.0000%	0.000%	0.100 <- %	20	\$3,000.00	\$30,000.00	\$900.00	\$3,900.00	\$27,000.00	\$30,000
21 Larry Bo	1950	n	\$20,000.00	0	0.0000%	0.000%	0.050 <- %	21	\$1,000.00	\$20,000.00	\$600.00	\$1,600.00	\$19,000.00	\$20,000
22 Rose Gie	1950	n	\$20,000.00	0	0.0000%	0.000%	0.100 <- %	22	\$2,000.00	\$20,000.00	\$600.00	\$2,600.00	\$18,000.00	\$20,000
23 Bill Root	1950	n	\$10,000.00	0	0.0000%	0.000%	0.000	23	\$0.00	\$10,000.00	\$0.00	\$0.00	\$10,000.00	\$10,000
24 Jim Red	1950	n	\$10,000.00	0	0.0000%	0.000%	0.050 <- %	24	\$500.00	\$10,000.00	\$300.00	\$800.00	\$9,500.00	\$10,000
25 Sam Toe	1950	n	\$10,000.00	0	0.0000%	0.000%	0.100 <- %	25	\$1,000.00	\$10,000.00	\$300.00	\$1,300.00	\$9,000.00	\$10,000
26 Bill Huff	1950	n	\$10,000.00	0	0.0000%	0.000%	0.999	26	\$9,700.00	\$10,000.00	\$300.00	\$10,000.00	\$300.00	\$10,000

SIMPLE PLANS (see Chapter 3)

401(K) SIMPLE PLAN for a Partnership

#2 --- ALTERNATIVE MATCHING --- #3 --- NONELECTIVE CONTRIBUTION ---

2.00% --- Statutory rate.

>> OPTION NOT AVAILABLE IN 401(K)

401(K) SIMPLE	W-2 Income/ .9235 NESE after 2% or	Nonowner Non-Selective Allocation	Salary Reduction Contribution	Non-Selective Contribution	Total SIMPLE Contribution	Owner % of Total E/er 27.78% <- Owner % of Nonelective \$35,000.00 <- Owner Total \$206,400.00 <- Nonowner Total \$241,400.00 <- Plan Total
#	0	\$209,000.00	\$4,017,925.00	\$32,400.00	\$241,400.00	
1	0	\$13,000.00	\$277,050.00	\$4,500.00	\$17,500.00	\$259,550.00
2	0	\$13,000.00	\$230,875.00	\$4,500.00	\$17,500.00	\$213,375.00
3	0	\$3,000.00	\$600,000.00	\$4,000.00	\$7,000.00	\$597,000.00
4	0	\$13,000.00	\$300,000.00	\$2,000.00	\$15,000.00	\$287,000.00
5	0	\$13,000.00	\$270,000.00	\$1,800.00	\$14,800.00	\$257,000.00
6	0	\$12,000.00	\$240,000.00	\$1,600.00	\$13,600.00	\$228,000.00
7	0	\$13,000.00	\$210,000.00	\$1,400.00	\$14,400.00	\$197,000.00
8	0	\$13,000.00	\$180,000.00	\$1,200.00	\$14,200.00	\$167,000.00
9	0	\$13,000.00	\$150,000.00	\$1,000.00	\$14,000.00	\$137,000.00
10	0	\$0.00	\$150,000.00	\$1,000.00	\$1,000.00	\$150,000.00
11	0	\$0.00	\$150,000.00	\$1,000.00	\$1,000.00	\$150,000.00
12	0	\$12,000.00	\$120,000.00	\$800.00	\$12,800.00	\$108,000.00
13	0	\$12,000.00	\$120,000.00	\$800.00	\$12,800.00	\$108,000.00
14	0	\$1,000.00	\$120,000.00	\$800.00	\$1,800.00	\$119,000.00
15	0	\$12,000.00	\$120,000.00	\$800.00	\$12,800.00	\$108,000.00
16	0	\$13,000.00	\$120,000.00	\$800.00	\$13,800.00	\$107,000.00
17	0	\$13,000.00	\$150,000.00	\$1,000.00	\$14,000.00	\$137,000.00
18	0	\$0.00	\$90,000.00	\$600.00	\$600.00	\$90,000.00
19	0	\$4,500.00	\$90,000.00	\$600.00	\$5,100.00	\$85,500.00
20	0	\$9,000.00	\$90,000.00	\$600.00	\$9,600.00	\$81,000.00
21	0	\$3,000.00	\$60,000.00	\$400.00	\$3,400.00	\$57,000.00
22	0	\$6,000.00	\$60,000.00	\$400.00	\$6,400.00	\$54,000.00
23	0	\$0.00	\$30,000.00	\$200.00	\$200.00	\$30,000.00
24	0	\$1,500.00	\$30,000.00	\$200.00	\$1,700.00	\$28,500.00
25	0	\$3,000.00	\$30,000.00	\$200.00	\$3,200.00	\$27,000.00
26	0	\$13,000.00	\$30,000.00	\$200.00	\$13,200.00	\$17,000.00

QP-SEP ILLUSTRATOR

* CORPORATE PROFIT-SHARING PLAN *

* NON-INTEGRATED CONTRIBUTIONS

** ALLOCATION OF DESIRED CONTRIBUTION **

** INTEGRATION METHOD: NOT INTEGRATED **

EMPLOYEES	2007 ALLOCATION COMPENSATION	PLAN ALLOCATION COMPENSATION MULTIPLIED BY 6.680838% BASE PERCENTAGE	PLAN COMPENSATION IN EXCESS OF \$0.00	EXCESS COMPENSATION MULTIPLIED BY 0.000000% DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT
Ted Nugent	\$225,000.00	\$15,031.89	\$225,000.00	\$0.00	\$15,031.89
Myra Klepper	\$225,000.00	\$15,031.89	\$225,000.00	\$0.00	\$15,031.89
Fred Newman	\$225,000.00	\$15,031.89	\$225,000.00	\$0.00	\$15,031.89
Candace Marc	\$225,000.00	\$15,031.89	\$225,000.00	\$0.00	\$15,031.89
Martin Censor	\$220,000.00	\$14,697.84	\$220,000.00	\$0.00	\$14,697.84
Quinn Quinton	\$180,000.00	\$12,025.51	\$180,000.00	\$0.00	\$12,025.51
Rachelle Thomas	\$170,000.00	\$11,357.42	\$170,000.00	\$0.00	\$11,357.42
Jimmy Hernandez	\$26,818.18	\$1,791.68	\$26,818.18	\$0.00	\$1,791.68
	\$1,496,818.18	\$100,000.00	\$1,496,818.18	\$0.00	\$100,000.00
Paul Auerbach	\$50,000.00	\$3,340.42	\$50,000.00	\$0.00	\$3,340.42
Steven Tuller	\$50,000.00	\$3,340.42	\$50,000.00	\$0.00	\$3,340.42
Marvin Gardens	\$45,000.00	\$3,006.38	\$45,000.00	\$0.00	\$3,006.38
Theodore Day	\$40,000.00	\$2,672.34	\$40,000.00	\$0.00	\$2,672.34
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$185,000.00	\$12,359.55	\$185,000.00	\$0.00	\$12,359.55
	\$1,681,818.18	\$112,359.55	\$1,681,818.18	\$0.00	\$112,359.55

QP-SEP ILLUSTRATION

* CORPORATE PROFIT-SHARING PLAN *

* INTEGRATED CONTRIBUTIONS

** ALLOCATION OF DESIRED CONTRIBUTION **

** INTEGRATION METHOD: IRS PERCENTAGE METHOD **

EMPLOYEES	2007 ALLOCATION CONTRIBUTION	PLAN ALLOCATION		PLAN COMPENSATION IN EXCESS OF \$19,500.00	EXCESS COMPENSATION MULTIPLIED BY DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT
		COMPENSATION MULTIPLIED BY BASE PERCENTAGE	3.524060%			
Ted Nugent	\$225,000.00	\$7,929.13	\$205,500.00	\$7,241.94	\$15,171.08	
Myra Klepper	\$225,000.00	\$7,929.13	\$205,500.00	\$7,241.94	\$15,171.08	
Fred Newman	\$225,000.00	\$7,929.13	\$205,500.00	\$7,241.94	\$15,171.08	
Candace Maret	\$225,000.00	\$7,929.13	\$205,500.00	\$7,241.94	\$15,171.08	
Martin Censor	\$220,000.00	\$7,752.93	\$200,500.00	\$7,065.74	\$14,818.67	
Quinn Quinton	\$180,000.00	\$6,343.31	\$160,500.00	\$5,656.12	\$11,999.42	
Rachelle Thomas	\$170,000.00	\$5,990.90	\$150,500.00	\$5,303.71	\$11,294.61	
Jimmy Hernandez	\$26,818.18	\$945.09	\$7,318.18	\$257.90	\$1,202.99	
	\$1,496,818.18	\$52,748.76	\$1,340,818.18	\$47,251.23	\$100,000.00	
Paul Auerbach	\$50,000.00	\$1,762.03	\$30,500.00	\$1,074.84	\$2,836.87	
Steven Tuller	\$50,000.00	\$1,762.03	\$30,500.00	\$1,074.84	\$2,836.87	
Marvin Gardens	\$45,000.00	\$1,585.83	\$25,500.00	\$898.64	\$2,484.46	
Theodore Day	\$40,000.00	\$1,409.62	\$20,500.00	\$722.43	\$2,132.06	
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	
	\$185,000.00	\$6,519.51	\$107,000.00	\$3,770.74	\$10,290.25	
	\$1,681,818.18	\$59,268.28	\$1,447,818.18	\$51,021.98	\$110,290.25	

QP-SEP ILLUSTRATOR

* CORPORATE PROFIT-SHARING PLAN *

* INTEGRATED CONTRIBUTIONS

** ALLOCATION OF DESIRED CONTRIBUTION **

** INTEGRATION METHOD: IRS PERCENTAGE METHOD **

EMPLOYEES	2007 ALLOCATION COMPENSATION	PLAN ALLOCATION		PLAN COMPENSATION IN EXCESS OF \$78,001.00	EXCESS COMPENSATION MULTIPLIED BY 4.130847% DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT
		COMPENSATION MULTIPLIED BY 4.130847% BASE PERCENTAGE	COMPENSATION MULTIPLIED BY 4.130847%			
Ted Nugent	\$225,000.00	\$9,294.40	\$146,999.00	\$146,999.00	\$6,072.30	\$15,366.71
Myra Klepper	\$225,000.00	\$9,294.40	\$146,999.00	\$146,999.00	\$6,072.30	\$15,366.71
Fred Newman	\$225,000.00	\$9,294.40	\$146,999.00	\$146,999.00	\$6,072.30	\$15,366.71
Candace Maret	\$225,000.00	\$9,294.40	\$146,999.00	\$146,999.00	\$6,072.30	\$15,366.71
Martin Censor	\$220,000.00	\$9,087.86	\$141,999.00	\$141,999.00	\$5,865.76	\$14,953.62
Quinn Quinton	\$180,000.00	\$7,435.52	\$101,999.00	\$101,999.00	\$4,213.42	\$11,648.95
Rachelle Thomas	\$170,000.00	\$7,022.44	\$91,999.00	\$91,999.00	\$3,800.34	\$10,822.78
Jimmy Hernandez	\$26,818.18	\$1,107.82	\$0.00	\$0.00	\$0.00	\$1,107.82
	\$1,496,818.18	\$63,831.26	\$923,993.00	\$923,993.00	\$38,168.73	\$100,000.00
Paul Auerbach	\$50,000.00	\$2,065.42	\$0.00	\$0.00	\$0.00	\$2,065.42
Steven Tuller	\$50,000.00	\$2,065.42	\$0.00	\$0.00	\$0.00	\$2,065.42
Marvin Gardens	\$45,000.00	\$1,858.88	\$0.00	\$0.00	\$0.00	\$1,858.88
Theodore Day	\$40,000.00	\$1,652.34	\$0.00	\$0.00	\$0.00	\$1,652.34
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$185,000.00	\$7,642.07	\$0.00	\$0.00	\$0.00	\$7,642.07
	\$1,681,818.18	\$69,473.33	\$923,993.00	\$923,993.00	\$38,168.73	\$107,642.06

QF-SEP ILLUSTRATOR

* CORPORATE PROFIT-SHARING PLAN *

* INTEGRATED CONTRIBUTIONS

** ALLOCATION OF DESIRED CONTRIBUTION **

** INTEGRATION METHOD: IRS PERCENTAGE METHOD **

EMPLOYEES	2007 ALLOCATION COMPENSATION	PLAN ALLOCATION		PLAN COMPENSATION IN EXCESS OF \$97,500.00	EXCESS COMPENSATION MULTIPLIED BY DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT
		COMPENSATION MULTIPLIED BY 4.130847%	BASE PERCENTAGE			
Ted Nugent	\$225,000.00	\$9,294.40		\$127,500.00	\$5,266.83	\$14,561.23
Myra Klepper	\$225,000.00	\$9,294.40		\$127,500.00	\$5,266.83	\$14,561.23
Fred Newman	\$225,000.00	\$9,294.40		\$127,500.00	\$5,266.83	\$14,561.23
Candace Maret	\$225,000.00	\$9,294.40		\$127,500.00	\$5,266.83	\$14,561.23
Martin Censor	\$220,000.00	\$9,087.86		\$122,500.00	\$5,060.29	\$14,148.15
Quinn Quinton	\$180,000.00	\$7,435.52		\$82,500.00	\$3,407.95	\$10,843.47
Rachelle Thomas	\$170,000.00	\$7,022.44		\$72,500.00	\$2,994.86	\$10,017.30
Jimmy Hernandez	\$26,818.18	\$1,107.82		\$0.00	\$0.00	\$1,107.82
	\$1,496,818.18	\$61,831.26		\$787,500.00	\$32,530.42	\$94,361.68
Paul Auerbach	\$50,000.00	\$2,065.42		\$0.00	\$0.00	\$2,065.42
Steven Tuller	\$50,000.00	\$2,065.42		\$0.00	\$0.00	\$2,065.42
Marvin Gardens	\$45,000.00	\$1,858.88		\$0.00	\$0.00	\$1,858.88
Theodore Day	\$40,000.00	\$1,652.34		\$0.00	\$0.00	\$1,652.34
	\$0.00	\$0.00		\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00		\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00		\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00		\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00		\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00		\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00		\$0.00	\$0.00	\$0.00
	\$185,000.00	\$7,642.07		\$0.00	\$0.00	\$7,642.07
	\$1,681,818.18	\$69,473.33		\$787,500.00	\$32,530.42	\$102,003.75

Money-Purchase Plan for a Partnership (Unusual Facts)

1

(See Chapter 7)

* UNUSUAL FACTS PARTNERSHIP (showing reduction of earned income)

* MONEY PURCHASE KEOGH PLAN *

Plan Year Begins: 2007 \$46,017.14 - Employer Contribution
 Plan Year Ends: 2007 ALL - DEDUCTIBLE PORTION
 Base Percentage: 10.00000000 \$46,017.14 - Total Contributions
 Integration Level: \$0 10.000000000% - Allocation % of Ded. Comp.
 Excess Percentage: 10.00000000 None - Integration
 1=1/S 2=MP 3=SEP 4=SIMSEP: 2
 E/er Cont. to Owners: 93.48%
 E/er Alloc. Compensation: 93.48% \$45,000.00 - Maximum Allocation

P	Prototype Plan	TOTAL ALLOCATION	ALLOCATION % OF DEDUCTION	EMPLOYER CONTRIBUTION	Columns reserved for Salary Reduction SEPs	K	E	EMPLOYEE'S PRE-PLAN EARNED INCOME
->	Plan not T/H							
1	Joe Normal	\$8,397.96	10.000000%	\$8,397.96		Y		\$100,000.00 Y
2	Lou - has W-2 income	\$8,478.54	10.000000%	\$8,478.54		Y		\$100,000.00 Y
3	Tom - has outside SE loss	\$8,462.19	10.000000%	\$8,462.19		Y		\$100,000.00 Y
4	Tim - has outside SE gain	\$8,415.71	10.000000%	\$8,415.71		Y		\$100,000.00 Y
5	Abe - is ineligible	\$0.00	0.000000%	\$0.00		Y		\$0.00 Y
6	Ros - is a guaranteed payment partner	\$9,262.73	10.000000%	\$9,262.73		Y		\$109,400.00 Y
7		\$0.00	0.000000%	\$0.00				
8		\$0.00	0.000000%	\$0.00				
	OWNER SUB-TOTALS	\$43,017.14		\$43,017.14				\$509,400.00
9	Nancy Nurse	\$1,000.00	10.000000%	\$1,000.00		N		\$10,000.00 N
10	Karl Cleaner	\$1,000.00	10.000000%	\$1,000.00		N		\$10,000.00 N
11	Ruth Ray	\$1,000.00	10.000000%	\$1,000.00		N		\$10,000.00 N
12		\$0.00	0.000000%	\$0.00				
13		\$0.00	0.000000%	\$0.00				
14		\$0.00	0.000000%	\$0.00				
15		\$0.00	0.000000%	\$0.00				
16		\$0.00	0.000000%	\$0.00				
17		\$0.00	0.000000%	\$0.00				
18		\$0.00	0.000000%	\$0.00				
	NON-OWNER SUB TOTALS	\$3,000.00		\$3,000.00				\$30,000.00
	GRAND TOTALS	\$46,017.14		\$46,017.14				\$539,400.00

* UNUSUAL FACTS PARTNERSHIP (showing reduction of earned income) 3
 \$46,017.14 - Employer Contribution
 ALL - DEDUCTIBLE PORTION
 \$46,017.14 - Total Contributions
 10.00% - Allocation % of Ded. Comp.
 None - Integration

* MONEY PURCHASE ROUGH PLAN *
 2007

* NON-INTEGRATED CONTRIBUTIONS

** CONTRIBUTION SUMMARY **

	EMPLOYEE	PRE-PLAN COMPENSATION	TOTAL ALLOCATION	EMPLOYER'S CONTRIBUTION	COL. n/a	ULTRA NET TAXABLE COMPENSATION	COL. n/a	EMPLOYER CONTRIBUTION % OF DEDUCT. COMPENSATION	PERCENTAGE OF EMPLOYER CONTRIBUTIONS	PERCENTAGE OF TOTAL \$46,017.14 ALLOCATIONS
	Joe Normal	\$100,000.00	\$8,397.96	\$8,397.96	n/a	\$84,579.65	n/a	10.00%	18.25%	18.25%
	Lou - has W-2 income	\$100,000.00	\$8,478.54	\$8,478.54	n/a	\$85,385.42	n/a	10.00%	18.42%	18.42%
	Tom - has outside SE loss	\$100,000.00	\$8,462.19	\$8,462.19	n/a	\$85,221.90	n/a	10.00%	18.39%	18.39%
	Tim - has outside SE gain	\$100,000.00	\$8,415.71	\$8,415.71	n/a	\$84,757.07	n/a	10.00%	18.29%	18.29%
	Abe - is ineligible	\$0.00	\$0.00	\$0.00	n/a	\$0.00	n/a	0.00%	0.00%	0.00%
	Ros - is a guaranteed payment partner	\$109,400.00	\$9,262.73	\$9,262.73	n/a	\$92,627.32	n/a	10.00%	20.13%	20.13%
		\$0.00	\$0.00	\$0.00	n/a	\$0.00	n/a	0.00%	0.00%	0.00%
		\$0.00	\$0.00	\$0.00	n/a	\$0.00	n/a	0.00%	0.00%	0.00%
	OWNER SUB-TOTALS	\$509,400.00	\$43,017.14	\$43,017.14					93.48%	93.48%
	Nancy Nurse	\$10,000.00	\$1,000.00	\$1,000.00	n/a	\$10,000.00	n/a	10.00%	2.17%	2.17%
	Karl Cleaner	\$10,000.00	\$1,000.00	\$1,000.00	n/a	\$10,000.00	n/a	10.00%	2.17%	2.17%
	Ruth Ray	\$10,000.00	\$1,000.00	\$1,000.00	n/a	\$10,000.00	n/a	10.00%	2.17%	2.17%
		\$0.00	\$0.00	\$0.00	n/a	\$0.00	n/a	0.00%	0.00%	0.00%
		\$0.00	\$0.00	\$0.00	n/a	\$0.00	n/a	0.00%	0.00%	0.00%
		\$0.00	\$0.00	\$0.00	n/a	\$0.00	n/a	0.00%	0.00%	0.00%
		\$0.00	\$0.00	\$0.00	n/a	\$0.00	n/a	0.00%	0.00%	0.00%
		\$0.00	\$0.00	\$0.00	n/a	\$0.00	n/a	0.00%	0.00%	0.00%
	NON-OWNER SUB TOTALS	\$30,000.00	\$3,000.00	\$3,000.00					6.52%	6.52%
	GRAND TOTALS	\$30,000.00	\$46,017.14	\$46,017.14					100.00%	100.00%

* UNUSUAL FACTS PARTNERSHIP (showing reduction of earned income)

* MONEY PURCHASE KEOGH PLAN *

* NON-INTEGRATED CONTRIBUTIONS

** ALLOCATION OF DESIRED CONTRIBUTION **

** INTEGRATION METHOD: NOT INTEGRATED **

EMPLOYEES	2007 ALLOCATION COMPENSATION	PLAN ALLOCATION COMPENSATION MULTIPLIED BY 10.000000% BASE PERCENTAGE	PLAN COMPENSATION IN EXCESS OF \$0.00	EXCESS COMPENSATION MULTIPLIED BY 0.000000% DISPARITY RATE	UNLIMITED TOTAL PLAN DEPOSIT
Joe Normal	\$83,979.65	\$8,397.96	\$83,979.65	\$0.00	\$8,397.96
Lou - has W-2 income	\$84,785.42	\$8,478.54	\$84,785.42	\$0.00	\$8,478.54
Tom - has outside SE loss	\$84,621.90	\$8,462.19	\$84,621.90	\$0.00	\$8,462.19
Tim - has outside SE gain	\$84,157.07	\$8,415.71	\$84,157.07	\$0.00	\$8,415.71
Abe - is ineligible	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Ros - is a guaranteed payment partner	\$92,627.32	\$9,262.73	\$92,627.32	\$0.00	\$9,262.73
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$430,171.36	\$43,017.14	\$430,171.36	\$0.00	\$43,017.14
Nancy Nurse	\$10,000.00	\$1,000.00	\$10,000.00	\$0.00	\$1,000.00
Karl Cleaner	\$10,000.00	\$1,000.00	\$10,000.00	\$0.00	\$1,000.00
Ruth Ray	\$10,000.00	\$1,000.00	\$10,000.00	\$0.00	\$1,000.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
	\$30,000.00	\$3,000.00	\$30,000.00	\$0.00	\$3,000.00
	\$460,171.36	\$46,017.14	\$460,171.36	\$0.00	\$46,017.14

* UNUSUAL FACTS PARTNERSHIP (showing reduction of earned income)

* MONEY PURCHASE KEOGH PLAN *

* NON-INTEGRATED CONTRIBUTIONS

* CONTRIBUTION LIMITATIONS

2007 MAXIMUM LIMITATIONS

	A		B		D		MULTI-CLASS FORMULA ALLOCATION LIMIT PERCENTAGE [Default \$0]
	UNLIMITED CONTRIBUTION AMOUNTS	SECTION 415 GENERAL LIMIT	Qualified Plan IPC - 415 100.00%	2007 MAXIMUM ALLOWABLE CONTRIBUTION	Lesser of: A or B or D	2007 MAXIMUM ALLOWABLE CONTRIBUTION	
EMPLOYEES							
Joe Normal	\$8,397.96	\$45,000.00	\$83,979.65	\$8,397.96	\$8,397.96	0.00000	
Lou - has W-2 income	\$8,478.54	\$45,000.00	\$84,785.42	\$8,478.54	\$8,478.54	0.00000	
Tom - has outside SE loss	\$8,462.19	\$45,000.00	\$84,621.90	\$8,462.19	\$8,462.19	0.00000	
Tim - has outside SE gain	\$8,415.71	\$45,000.00	\$84,157.07	\$8,415.71	\$8,415.71	0.00000	
Abe - is ineligible	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000	
Ros - is a guaranteed payment partner	\$9,262.73	\$45,000.00	\$92,627.32	\$9,262.73	\$9,262.73	0.00000	
	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000	
	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000	

OWNER SUB-TOTALS

Nancy Nurse	\$1,000.00	\$45,000.00	\$10,000.00	\$1,000.00	\$1,000.00	0.00000
Karl Cleaner	\$1,000.00	\$45,000.00	\$10,000.00	\$1,000.00	\$1,000.00	0.00000
Ruth Ray	\$1,000.00	\$45,000.00	\$10,000.00	\$1,000.00	\$1,000.00	0.00000
	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000
	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000
	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000
	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000
	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000
	\$0.00	n/a	\$0.00	\$0.00	\$0.00	0.00000

Do not contribute amounts shown on this page.

Appendix C

IRA Contribution Worksheets for Recipients of Social Security

If you receive social security benefits, have taxable compensation, contribute to your traditional IRA, and you or your spouse is covered by an employer retirement plan, complete the following worksheets. (See *Are You Covered by an Employer Plan?* in chapter 1.) Use Worksheet 1 to figure your modified adjusted gross income. This amount is needed in the computation of your IRA deduction, if any, which is figured using Worksheet 2. The IRA deduction figured using Worksheet 2 is entered on your tax return.

Worksheet 1
Computation of Modified AGI
(For use only by taxpayers who receive social security benefits)

Filing Status — Check only one box:

- A.** Married filing jointly
- B.** Single, Head of Household, Qualifying Widow(er), or Married filing separately and **lived apart** from your spouse during the **entire year**
- C.** Married filing separately and **lived with** your spouse at **any time** during the year

<p>1. Adjusted gross income (AGI) from Form 1040 or Form 1040A (not taking into account any social security benefits from Form SSA-1099 or RRB-1099, any deduction for contributions to a traditional IRA, any student loan interest deduction, any tuition and fees deduction, any domestic production activities deduction, or any exclusion of interest from savings bonds to be reported on Form 8815)</p> <p>2. Enter the amount in box 5 of all Forms SSA-1099 and Forms RRB-1099</p> <p>3. Enter one-half of line 2</p> <p>4. Enter the amount of any foreign earned income exclusion, foreign housing exclusion, U.S. possessions income exclusion, exclusion of income from Puerto Rico you claimed as a bona fide resident of Puerto Rico, or exclusion of employer-provided adoption benefits</p> <p>5. Enter the amount of any tax-exempt interest reported on line 8b of Form 1040 or 1040A</p> <p>6. Add lines 1, 3, 4, and 5</p> <p>7. Enter the amount listed below for your filing status.</p> <ul style="list-style-type: none"> • \$32,000 if you checked box A above. • \$25,000 if you checked box B above. • \$0 if you checked box C above. <p>8. Subtract line 7 from line 6. If zero or less, enter 0 on this line</p> <p>9. If line 8 is zero, stop here. None of your social security benefits are taxable. If line 8 is more than 0, enter the amount listed below for your filing status.</p> <ul style="list-style-type: none"> • \$12,000 if you checked box A above. • \$9,000 if you checked box B above. • \$0 if you checked box C above. <p>10. Subtract line 9 from line 8. If zero or less, enter 0</p> <p>11. Enter the smaller of line 8 or line 9</p> <p>12. Enter one-half of line 11</p> <p>13. Enter the smaller of line 3 or line 12</p> <p>14. Multiply line 10 by .85. If line 10 is zero, enter 0</p> <p>15. Add lines 13 and 14</p> <p>16. Multiply line 2 by .85</p> <p>17. Taxable benefits to be included in modified AGI for traditional IRA deduction purposes. Enter the smaller of line 15 or line 16</p> <p>18. Enter the amount of any employer-provided adoption benefits exclusion and any foreign earned income exclusion and foreign housing exclusion or deduction that you claimed</p> <p>19. Modified AGI for determining your reduced traditional IRA deduction — add lines 1, 17, and 18. Enter here and on line 2 of Worksheet 2, next</p>	<p>1. _____</p> <p>2. _____</p> <p>3. _____</p> <p>4. _____</p> <p>5. _____</p> <p>6. _____</p> <p>7. _____</p> <p>8. _____</p> <p>9. _____</p> <p>10. _____</p> <p>11. _____</p> <p>12. _____</p> <p>13. _____</p> <p>14. _____</p> <p>15. _____</p> <p>16. _____</p> <p>17. _____</p> <p>18. _____</p> <p>19. _____</p>
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Worksheet 2
Computation of Traditional IRA Deduction For 2006
(For use only by taxpayers who receive social security benefits)

IF your filing status is ...	AND your modified AGI is over ...	THEN enter on line 1 below ...
married filing jointly AND		
•you are covered by a retirement plan at work, or	\$75,000*	\$85,000
•you are not covered by an employer plan but your spouse is	\$150,000*	\$160,000
single, or head of household	\$50,000*	\$60,000
married filing separately**	\$0*	\$10,000
qualifying widow(er)	\$75,000*	\$85,000

*If your modified AGI is **not** over this amount, you can take an IRA deduction for your contributions of up to the lesser of \$4,000 (\$5,000 if you are 50 or older) or your taxable compensation. Skip this worksheet, proceed to Worksheet 3, and enter your IRA deduction on line 2 of Worksheet 3.

If you did **not live with your spouse at any time during the year, consider your filing status as single.

Note. If you were married and you or your spouse worked and you both contributed to IRAs, figure the deduction for each of you separately.

1. Enter the applicable amount from above 1. _____
2. Enter your **modified AGI** from Worksheet 1, line 19 2. _____
Note. If line 2 is equal to or more than the amount on line 1, **stop here**; your traditional IRA contributions are not deductible. Proceed to Worksheet 3.
3. Subtract line 2 from line 1 3. _____
4. Multiply line 3 by 40% (.40) (by 50% (.50) if you are age 50 or older). If the result is not a multiple of \$10, round it to the next highest multiple of \$10. (For example, \$611.40 is rounded to \$620.) However, if the result is less than \$200, enter \$200. 4. _____
5. Enter your compensation minus any deductions on Form 1040, line 27 (one-half of self-employment tax) and line 28 (self-employed SEP, SIMPLE, and qualified plans). (If you are the lower-income spouse, include your spouse's compensation reduced by his or her traditional IRA and Roth IRA contributions for this year.) 5. _____
6. Enter contributions you made, or plan to make, to your traditional IRA for 2006, but do not enter more than \$4,000 (\$5,000 if you are age 50 or older) 6. _____
7. **Deduction.** Compare lines 4, 5, and 6. Enter the smallest amount here (or a smaller amount if you choose). Enter this amount on the Form 1040 or 1040A line for your IRA. (If the amount on line 6 is more than the amount on line 7, complete line 8.) 7. _____
8. **Nondeductible contributions.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606, *Nondeductible IRAs*. 8. _____

Worksheet 3
Computation of Taxable Social Security Benefits
(For use by taxpayers who receive social security benefits and take a traditional IRA deduction)

Filing Status — Check only one box:

- A.** Married filing jointly
- B.** Single, Head of Household, Qualifying Widow(er), or Married filing separately and **lived apart** from your spouse during the **entire year**
- C.** Married filing separately and **lived with** your spouse at **any time** during the year

<p>1. Adjusted gross income (AGI) from Form 1040 or Form 1040A (not taking into account any IRA deduction, any student loan interest deduction, any tuition and fees deduction, any domestic production activities deduction, any social security benefits from Form SSA-1099 or RRB-1099, or any exclusion of interest from savings bonds to be reported on Form 8815)</p> <p>2. Deduction(s) from line 7 of Worksheet(s)</p> <p>3. Subtract line 2 from line 1</p> <p>4. Enter amount in box 5 of all Forms SSA-1099 and Forms RRB-1099</p> <p>5. Enter one-half of line 4</p> <p>6. Enter the amount of any foreign earned income exclusion, foreign housing exclusion, exclusion of income from U.S. possessions, exclusion of income from Puerto Rico you claimed as a bona fide resident of Puerto Rico, or exclusion of employer-provided adoption benefits</p> <p>7. Enter the amount of any tax-exempt interest reported on line 8b of Form 1040 or 1040A</p> <p>8. Add lines 3, 5, 6, and 7</p> <p>9. Enter the amount listed below for your filing status. • \$32,000 if you checked box A above. • \$25,000 if you checked box B above. • \$0 if you checked box C above.</p> <p>10. Subtract line 9 from line 8. If zero or less, enter 0 on this line.</p> <p>11. If line 10 is zero, stop here. None of your social security benefits are taxable. If line 10 is more than 0, enter the amount listed below for your filing status. • \$12,000 if you checked box A above. • \$9,000 if you checked box B above. • \$0 if you checked box C above.</p> <p>12. Subtract line 11 from line 10. If zero or less, enter 0</p> <p>13. Enter the smaller of line 10 or line 11</p> <p>14. Enter one-half of line 13 0.</p> <p>15. Enter the smaller of line 5 or line 14</p> <p>16. Multiply line 12 by .85. If line 12 is zero, enter 0</p> <p>17. Add lines 15 and 16</p> <p>18. Multiply line 4 by .85</p> <p>19. Taxable social security benefits. Enter the smaller of line 17 or line 18</p>	<p>1. _____</p> <p>2. _____</p> <p>3. _____</p> <p>4. _____</p> <p>5. _____</p> <p>6. _____</p> <p>7. _____</p> <p>8. _____</p> <p>9. _____</p> <p>10. _____</p> <p>11. _____</p> <p>12. _____</p> <p>13. _____</p> <p>14. _____</p> <p>15. _____</p> <p>16. _____</p> <p>17. _____</p> <p>18. _____</p> <p>19. _____</p>
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Comprehensive Example
Determining Your Traditional IRA Deduction and the Taxable Portion of Your Social Security Benefits

John Black is married and files a joint return. He is 65 years old and had 2006 wages of \$68,500. His wife did not work in 2006. He also received social security benefits of \$10,000 and made a \$5,000 contribution to his traditional IRA for the year. He had no foreign income, no tax-exempt interest, and no adjustments to income on lines 23 through 36 on his Form 1040. He participated in a section 401(k) retirement plan at work.

John completes worksheets 1 and 2. Worksheet 2 shows that his 2006 IRA deduction is \$4,000. He must either withdraw the contributions that are more than the deduction (the \$1,000 shown on line 8 of Worksheet 2), or treat the excess amounts as nondeductible contributions (in which case he must complete Form 8606 and attach it to his Form 1040).

The completed worksheets that follow show how John figured his modified AGI to determine the IRA deduction and the taxable social security benefits to report on his Form 1040.

Worksheet 1
Computation of Modified AGI
(For use only by taxpayers who receive social security benefits)

Filing Status — Check only one box:

- A.** Married filing jointly
- B.** Single, Head of Household, Qualifying Widow(er), or Married filing separately and *lived apart* from your spouse during the *entire year*
- C.** Married filing separately and *lived with* your spouse at *any time* during the year

<p>1. Adjusted gross income (AGI) from Form 1040 or Form 1040A (not taking into account any social security benefits from Form SSA-1099 or RRB-1099, any deduction for contributions to a traditional IRA, any student loan interest deduction, any tuition and fees deduction, any domestic production activities deduction, or any exclusion of interest from savings bonds to be reported on Form 8815)</p> <p>2. Enter the amount in box 5 of all Forms SSA-1099 and Forms RRB-1099</p> <p>3. Enter one-half of line 2</p> <p>4. Enter the amount of any foreign earned income exclusion, foreign housing exclusion, U.S. possessions income exclusion, exclusion of income from Puerto Rico you claimed as a bona fide resident of Puerto Rico, or exclusion of employer-provided adoption benefits</p> <p>5. Enter the amount of any tax-exempt interest reported on line 8b of Form 1040 or 1040A</p> <p>6. Add lines 1, 3, 4, and 5</p> <p>7. Enter the amount listed below for your filing status.</p> <ul style="list-style-type: none"> • \$32,000 if you checked box A above. • \$25,000 if you checked box B above. • \$0 if you checked box C above. <p>8. Subtract line 7 from line 6. If zero or less, enter 0 on this line</p> <p>9. If line 8 is zero, stop here. None of your social security benefits are taxable. If line 8 is more than 0, enter the amount listed below for your filing status.</p> <ul style="list-style-type: none"> • \$12,000 if you checked box A above. • \$9,000 if you checked box B above. • \$0 if you checked box C above. <p>10. Subtract line 9 from line 8. If zero or less, enter 0</p> <p>11. Enter the smaller of line 8 or line 9</p> <p>12. Enter one-half of line 11</p> <p>13. Enter the smaller of line 3 or line 12</p> <p>14. Multiply line 10 by .85. If line 10 is zero, enter 0</p> <p>15. Add lines 13 and 14</p> <p>16. Multiply line 2 by .85</p> <p>17. Taxable benefits to be included in Modified AGI for traditional IRA deduction purposes. Enter the smaller of line 15 or line 16</p> <p>18. Enter the amount of any employer-provided adoption benefits exclusion and any foreign earned income exclusion and foreign housing exclusion or deduction that you claimed</p> <p>19. Modified AGI for determining your reduced traditional IRA deduction — add lines 1, 17, and 18. Enter here and on line 2 of Worksheet 2, next</p>	<p>68,500</p> <p>10,000</p> <p>5,000</p> <p>0</p> <p>0</p> <p>73,500</p> <p>32,000</p> <p>41,500</p> <p>12,000</p> <p>29,500</p> <p>12,000</p> <p>6,000</p> <p>5,000</p> <p>25,075</p> <p>30,075</p> <p>8,500</p> <p>8,500</p> <p>0</p> <p>77,000</p>
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Worksheet 2 Computation of Traditional IRA Deduction For 2006 (For use only by taxpayers who receive social security benefits)		
IF your filing status is ...	AND your modified AGI is over ...	THEN enter on line 1 below ...
married filing jointly or qualifying widow(er)	\$75,000*	\$85,000
married filing jointly (you are not covered by an employer plan but your spouse is)	\$150,000*	\$160,000
single, or head of household	\$50,000*	\$60,000
married filing separately**	\$0*	\$10,000

*If your modified AGI is **not** over this amount, you can take an IRA deduction for your contributions of up to the lesser of \$4,000 (\$5,000 if you are age 50 or older) or your taxable compensation. Skip this worksheet, proceed to Worksheet 3, and enter your IRA deduction on line 2 of Worksheet 3.

If you did **not live with your spouse **at any time** during the year, consider your filing status as single.

Note. If you were married and you or your spouse worked and you both contributed to IRAs, figure the deduction for each of you separately.

1. Enter the applicable amount from above	<u>85,000</u>
2. Enter your modified AGI from Worksheet 1, line 19	<u>77,000</u>
Note. If line 2 is equal to or more than the amount on line 1, stop here ; your traditional IRA contributions are not deductible. Proceed to Worksheet 3.	
3. Subtract line 2 from line 1	<u>8,000</u>
4. Multiply line 3 by 40% (.40) (by 50% (.50) if you are age 50 or older). If the result is not a multiple of \$10, round it to the next highest multiple of \$10. (For example, \$611.40 is rounded to \$620.) However, if the result is less than \$200, enter \$200.	<u>4,000</u>
5. Enter your compensation minus any deductions on Form 1040, line 27 (one-half of self-employment tax) and line 28 (self-employed SEP, SIMPLE, and qualified plans). (If you are the lower-income spouse, include your spouse's compensation reduced by his or her traditional IRA and Roth IRA contributions for this year	<u>68,500</u>
6. Enter contributions you made, or plan to make, to your traditional IRA for 2005, but do not enter more than \$4,000 (\$5,000 if you are age 50 or older)	<u>5,000</u>
7. Deduction. Compare lines 4, 5, and 6. Enter the smallest amount here (or a smaller amount if you choose). Enter this amount on the Form 1040 or 1040A line for your IRA. (If the amount on line 6 is more than the amount on line 7, complete line 8.)	<u>4,000</u>
8. Nondeductible contributions. Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606, <i>Nondeductible IRAs</i>	<u>1,000</u>

Worksheet 3

Computation of Taxable Social Security Benefits

(For use by taxpayers who receive social security benefits and take a traditional IRA deduction)

Filing Status — Check only one box:

- A.** Married filing jointly
- B.** Single, Head of Household, Qualifying Widow(er), or Married filing separately and *lived apart* from your spouse during the *entire year*
- C.** Married filing separately and *lived with* your spouse at *any time* during the year

1. Adjusted gross income (AGI) from Form 1040 or Form 1040A (not taking into account any IRA deduction, any student loan interest deduction, any tuition and fees deduction, any domestic production activities deduction, any social security benefits from Form SSA-1099 or RRB-1099, or any exclusion of interest from savings bonds to be reported on Form 8815)	<u>68,500</u>
2. Deduction(s) from line 7 of Worksheet(s) 2	<u>4,000</u>
3. Subtract line 2 from line 1	<u>64,500</u>
4. Enter amount in box 5 of all Forms SSA-1099 and Forms RRB-1099	<u>10,000</u>
5. Enter one-half of line 4	<u>5,000</u>
6. Enter the amount of any foreign earned income exclusion, foreign housing exclusion, exclusion of income from U.S. possessions, exclusion of income from Puerto Rico you claimed as a bona fide resident of Puerto Rico, or exclusion of employer-provided adoption benefits	<u>0</u>
7. Enter the amount of any tax-exempt interest reported on line 8b of Form 1040 or 1040A	<u>0</u>
8. Add lines 3, 5, 6, and 7	<u>69,500</u>
9. Enter the amount listed below for your filing status. • \$32,000 if you checked box A above. • \$25,000 if you checked box B above. • \$0 if you checked box C above.	<u>32,000</u>
10. Subtract line 9 from line 8. If zero or less, enter 0 on this line.	<u>37,500</u>
11. If line 10 is zero, stop here . None of your social security benefits are taxable. If line 10 is more than 0, enter the amount listed below for your filing status. • \$12,000 if you checked box A above. • \$9,000 if you checked box B above. • \$0 if you checked box C above.	<u>12,000</u>
12. Subtract line 11 from line 10. If zero or less, enter 0	<u>25,500</u>
13. Enter the smaller of line 10 or line 11	<u>12,000</u>
14. Enter one-half of line 13	<u>6,000</u>
15. Enter the smaller of line 5 or line 14	<u>5,000</u>
16. Multiply line 12 by .85. If line 12 is zero, enter 0	<u>21,675</u>
17. Add lines 15 and 16	<u>26,675</u>
18. Multiply line 4 by .85	<u>8,500</u>
19. Taxable social security benefits. Enter the smaller of line 17 or line 18	<u>8,500</u>

Appendix D

Indexing of Employee Benefits and Related Limits

Many of the dollar thresholds used in limiting the level of benefits available through tax-advantaged programs are adjusted to reflect changes in the consumer price index (CPI) relative to the base period used for each limit. The limit for a particular year is adjusted based on the cumulative increase through the third quarter of the preceding calendar year. The adjusted limits are then rounded down to the nearest multiplier specified for the particular limit. The limits for 2007, for example, are based on the CPI factors through the third quarter of 2006.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) overrides many of the pre-EGTRRA CPI adjustments with specific increases over a five-year period before CPI increases restart for items with fixed increments. Exhibit D-1 reflects these fixed limits.

Exhibit D-1. Employee Benefits and Related Limits

Purpose	2005	2006	2007
General 402(g) elective deferral limit— 401(k), 403(b), and SEP	\$ 14,000	\$ 15,000	\$ 15,500
Elective 457 deferral limit ¹	\$ 14,000	\$ 15,000	\$ 15,500
Catch-up deferrals— 401(k), 403(b), 457, and SARSEP ²	\$ 4,000	\$ 5,000	\$ 5,000
Elective SIMPLE IRA and SIMPLE 401(k) deferral limit ²	\$ 10,000	\$ 10,000	\$ 10,500
Catch-up deferrals— SIMPLE IRA and SIMPLE 401(k) ²	\$ 2,000	\$ 2,500	\$ 2,500
IRA/Roth-IRA annual contribution limit	\$ 4,000	\$ 4,000	\$ 4,000 ³
IRA/Roth-IRA catch-up contributions ²	\$ 500	\$ 1,000	\$ 1,000 ³
DB ⁴ maximum benefit	\$170,000	\$175,000	\$180,000
DC ⁵ maximum addition	\$ 42,000	\$ 44,000	\$ 45,000
HCE compensation ⁶	\$ 95,000	\$100,000	\$100,000
Key employee:			
Officer ⁷	\$135,000	\$140,000	\$145,000
1% Owners	\$150,000	\$150,000	\$150,000
Compensation limit ⁸	\$210,000	\$220,000	\$225,000
SEP threshold	\$ 450	\$ 450	\$ 500
ESOP (5-year distribution factor)	\$170,000	\$175,000	\$180,000
ESOP (account balance)	\$850,000	\$885,000	\$915,000
Taxable wage base	\$ 90,000	\$ 94,200	\$ 97,500
Employer provided parking (monthly)	\$ 200	\$ 205	\$ 215
Mass transit pass and vanpool (monthly)	\$ 105	\$ 105	\$ 110
HSA individual contribution limit ⁹	\$ 2,650	\$ 2,700	\$ 2,850
HSA family contribution limit ⁹	\$ 5,250	\$ 5,450	\$ 5,650
HSA catch up contributions	\$ 600	\$ 700	\$ 800
SECA tax for self-employed individuals, combined rate	15.3%	15.3%	15.3%
Old-age, survivors, and disability insurance tax rate	12.4%	12.4%	12.4%
Hospital insurance (Medicare)	2.9%	2.9%	2.9%
Social Security tax paid by both employee and employer	7.65%	7.65%	7.65%
Old-age, survivors, and disability insurance tax rate	6.20%	6.20%	6.20%
Hospital insurance (Medicare) ⁴	1.45%	1.45%	1.45%

¹ For governmental 457 plans, catch-up contributions under special rules of IRC § 457 during the three years prior to retirement may result in greater catch-up limits than the general catch-up contributions under IRC § 414(v) as reflected in chart.

² This number represents the catch-up limit available under Internal Revenue Code (IRC) Section 414(v). IRC Sections 457(b)(3) and 402(g)(8) provide separate catch-up rules that must also be considered in an appropriate situation.

³ For 2008, the IRA/Roth annual contribution limit will increase to \$5,000, and be adjusted for inflation thereafter. The IRA/Roth catch-up contribution limit will remain fixed at \$1,000 after 2006.

⁴ Defined benefit limit applies to limitation years ending in indicated year.

⁵ Defined contribution limit applies to limitation years ending in indicated year.

⁶ Compensation during the plan year beginning in the indicated year identifies highly compensated employees for the following plan year.

⁷ Generally, compensation during the determination year ending in the indicated year identifies key employees for the following plan year.

⁸ Compensation limit applies to plan years beginning in indicated year. Annual compensation limits for certain eligible participants in governmental plans that followed IRC § 401(a)(17) limits (with indexing) on July 1, 1993 are: \$335,000 for 2007, \$325,000 for 2006, and \$315,000 for 2005.

⁹ For taxable years beginning before 2007, the deductible contribution limit may not be more than the deductible under the HDHP associated with the HSA. For taxable years beginning after 2006, the HDHP's deductible limit on HSA contributions was repealed.

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